FIRST CONCURRENT RESOLUTION ON THE BUDGET—FISCAL YEAR 1983

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BEFORE THE

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ECONOMIC POLICY

FEBRUARY 23, 1982 FEBRUARY 24, 1982 MARCH 4, 1982	VIEWS OF THE REAGAN ADMINISTRATION
MARCH 2, 1982	VIEWS OF THE CHAIRMAN OF THE FEDERAL RESERVE SYSTEM VIEWS OF THE CONGRESSIONAL BUDGET OFFICE
MARCH 1, 1982 MARCH 5, 1982	VIEWS OF OUTSIDE ECONOMISTS

MARCH 15, 1982—VIEWS OF THE JOINT ECONOMIC COMMITTEE

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VIEWS OF THE REAGAN ADMINISTRATION

TUESDAY, FEBRUARY 23, 1982

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met, pursuant to notice, at 10:08 a.m., in room 6202, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Armstrong, Boschwitz, Symms, Grassley, Kasten, Quayle, Gorton, Hollings, Chiles, Biden, Johnston, Hart, Metzenbaum, Riegle, and Exon.

Staff present: Stephen Bell, staff director; Gail Fosler, chief economist; Lizabeth Tankersley, minority staff director; and Kemble Stokes, chief economist for the minority.

Chairman DOMENICI. Can we have order, please?

I have to say to my colleagues that I have to leave in about 6 or 7 minutes and go to the White House with the Republican leadership. Senator Armstrong will be along shortly and will preside on our side.

Senator HOLLINGS. I thought we had Republican leadership there. What is that fellow doing? [Laughter.]

Chairman DOMENICI. Well, he is not going to be there because it is very important that he be here. Secretary Regan is in finance, so I guess we will be without the Presidential advisers.

Senator BOSCHWITZ. I want to wish you luck down there, Mr. Chairman. [Laughter.]

Chairman DOMENICI. Well, Senator, we will keep trying.

I want to suggest that we attempt to follow the same rules that we have in the past. I do not want to keep anyone from their views expressed or asking questions, but I am somewhat concerned that if we all make opening statements, we will not get to the questioning of Mr. Stockman.

Frankly, if we will go along with the idea of reserving our opening statements to our question period, I will defer mine and we will get on with his testimony. We will then proceed with Senator Armstrong taking my place and leading off with the questions, and then right down the line, based upon arrival time.

Is that satisfactory to everyone?

Senator CHILES. Mr. Chairman, I wonder if Mr. Stockman is going to make a long presentation to us? If people do have an opening statement, could we have 3 to 5 minutes to make it before we listen to a long presentation?

Chairman DOMENICI. Mr. Stockman, how long will your opening statement be?

Mr. STOCKMAN. Mr. Chairman, I will try to limit it to about 20 minutes.

Chairman DOMENICI. Is that satisfactory, Senator Chiles? You would be third, so you will certainly get your full time.

Senator METZENBAUM. What is the time allocation for each member?

Chairman DOMENICI. We are going to follow the same rule that we have, in the past, 5 minutes per member, based on time of arrival. This would mean that everybody here would certainly get their 5 minutes, and probably a second go-around.

Senator GRASSLEY. Mr. Chairman, do you alternate between minority and majority, or is it just the way they come, regardless of——

Chairman DOMENICI. We alternate; we will try to continue to do that. I will just suggest, Mr. Stockman, that we are probably more familiar than we have been in the past with the proposals that you have made to us on behalf of the President. I do not think I would be remiss in suggesting that there remains a very great concern on this committee, and it is kind of a prevailing concern with respect to the size of the deficit not only in 1983, but in 1984, 1985, and 1986.

I think there is a growing concern that that sized deficit goes to the heart of the reason why we have such high interest rates. I know you are prepared to address that issue, but I think I would be remiss if I did not tell you that I have talked to many members of this committee and believe that they are expressing the feelings of a growing consensus, at least in the U.S. Senate, on that score.

With that, we will make your entire prepared remarks a part of the record and ask you to proceed. We are glad to have you, Mr. Stockman.

STATEMENT OF HON. DAVID A. STOCKMAN, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. STOCKMAN. Well, thank you very much, Mr. Chairman.

In view of the interest on the committee for asking detailed questions about the program, I would like to omit any comment about that. You have had time to examine and digest it. But I would like to spend a few minutes at the opening attempting to analyze the fiscal and economic context that we are in today and how some of those factors have shaped the size of the budget that we are facing and the deficit problems that this committee and everyone else is concerned about.

So, with the indulgence of the committee, I would like to go through some of the preliminary material in my statement, to try to establish a foundation and a context for the very difficult policy choices and the fact that there are no easy answers as we go about the 1983 budget.

NATION FACES CONTINUOUS DEFICITS OF UNPRECEDENTED SIZE

If we look at that context, Mr. Chairman, I think four things stand out immediately. The first is that in the absence of a comprehensive budget savings effort—either what we have proposed or some better and workable idea from the Hill—the Nation faces continuous deficits of unprecedented size in the years ahead.

On a current services basis—and that means with no further policy action—if we simply sit on our hands, the projected deficits range, depending upon whether you use optimistic, moderate or pessimistic economic assumptions, from $129 to $162 billion in fiscal year 1983, from $133 to nearly $200 billion in fiscal year 1984, and even larger numbers in fiscal year 1985.

PRESIDENT'S PLAN DESIGNED TO REDUCE DEFICITS

The second point that stands out is that the President's comprehensive budget savings plan contained in this fiscal year 1983 budget is designed to reduce dramatically these prospective current services deficits and insure that they decline steadily from the peak 1982 recession level of about $100 billion.

As this committee is aware, the President's plan would, if put in place, reduce the deficit by $56 billion in fiscal year 1983, $84 billion in 1984, and $99 billion in 1985, for a 3-year total savings on the deficit of $239 billion, or half of the prospective current services deficit that we face.

If we can implement actions and savings on both the revenue and the outlay side of this magnitude, we can insure that the deficits are cut in half, that they remain below the recession peak, and that they trend downward in the outyears as the recovery gains force.

REMAINING DEFICITS DUE TO CHANGES IN ECONOMIC OUTLOOK

The third point I would make, Mr. Chairman, is that the remaining deficits, after all of this policy action and budget savings are achieved, are due to changes in the economic outlook since last February, including the recession that was forecast by no one, the higher interest rates that we have experienced, and a more rapid than-anticipated slowdown in inflation.

All of these forces of economic transition have driven the budget toward greater imbalance and were uniformly underestimated by all budget and economic forecasts of 1 year ago.

Budget projections based on economic forecasts issued by this administration, by CBO, by DRI, and by the Carter outgoing January budget would have underestimated the current deficits by a large magnitude—$31 to $57 billion in 1982, $40 to $89 billion for 1983, and like numbers in the outyears.

[Whereupon, Senator Armstrong assumed the chair.]

CURRENT SERVICES DEFICIT OF SAME MAGNITUDE

Mr. STOCKMAN. Fourth, the overall point I would make to the committee this morning, Mr. Chairman, is that the current services deficit that requires this urgent, major, and sweeping action this year is of roughly the same magnitude, whether calculated from the actual administration tax and budget program enacted by the Congress last year or from the alternative fiscal program embodied in the Ways and Means tax bill and in the first budget resolution offered in the House.

What I am saying here is that our present fiscal predicament is a common consequence of current and future economic forces impacting the budget, not a consequence of fiscal policy options chosen or rejected last year. On page 3 of my prepared statement,[1] I indicate very clearly that the $146 to $160 billion current services deficit under the program that we have in place today is not appreciably different from a current services deficit estimated with the alternative programs that were offered in the Congress last year.

Let me spend a few moments now trying to indicate what factors have changed in the economic outlook and in the economic forecasts that generate these large current services deficit numbers and the need for urgent and sweeping action this year.

RANGE OF CURRENT SERVICES DEFICIT PROJECTIONS

The appropriate place to start, of course, is to recognize the range of budgetary projections at current services, which indicates what would happen if we sit on our hands and allow the budget momentum to run forward on automatic pilot.

These projections, under any economic assumptions that you use—optimistic, pessimistic, moderate, or otherwise—indicate serious danger to the economic recovery that we expect and that we need for financial markets, lower interest rates, and the economic well-being of every American family.

The table that we have provided on page 6 of my prepared statement,[2] shows a range of current service deficit projections for 1983 to 1985, the period that you will be addressing in your budget resolution, based on the administration economic forecast and two alternate forecasts, so that the whole range of possible outcomes is indicated.

Our forecast, of course, assumes that the recovery begins in 1982; that the average real GNP growth rate is slightly under 5 percent over the 1983–1985 period; that inflation, by the end of 1985, falls to 4.7 percent, that the unemployment rate comes down; and the T-bill rate comes down to about 8.5 percent by the end of 1985.

Now, if you do not choose to accept that forecast, you can take a higher growth-lower inflation forecast, which we have called the higher growth scenario. That scenario assumes average real growth 1.2 percent higher than the administration forecast, and correspondingly lower inflation and interest rates.

Or, if you are of the other bent or attitude about this, you can take the lower growth scenario, which assumes a less robust recovery 1.2 percent average real GNP growth lower over the 1983–1985 period, with commensurately higher inflation and interest rates.

COMPREHENSIVE POLICY ACTION NEEDED

My point this morning, Mr. Chairman, is simply that the deficit threat to fiscal balance and economic recovery transcends the plausible range of economic assumptions. Whether you use the low growth, the high growth or the administration forecast, comprehensive policy action is needed, is unavoidable, and is urgent.

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[1] See p. 65.
[2] See p. 68.

Without that kind of action, the current service deficit exceeds $120 billion in each and every year from 1983 to 1985 under any economic forecast you use, even the most optimistic that we have provided here for the information and analysis of the committee.

RISING DEFICIT DURING RECOVERY PERIOD IS INTOLERABLE

The second point is that the size of the deficit steadily increases under any of these forecasts after the '82 recession, which is just the opposite movement we need if the recovery is to move forward.

A recession deficit is one thing; a rising deficit during the recovery period, where there is certain to be a clash between the borrowing demands of Government and the rising credit needs of the private sector is intolerable and impermissible. And yet, without policy action, deficits rising in the outyears will occur under any economic assumptions.

Perhaps most dramatic and most worrisome to me is that if we do not get action this year to reduce dramatically the prospective deficits for 1983 to 1985, we run the risk of adding nearly a half trillion dollars to the national debt over the short course of 4 years; a little less with a better economic performance, and a little more with a worse economic performance.

But there is one-half trillion dollars in national debt staring us in the face unless this Congress and this administration, working together, can devise a plan to reduce these deficits.

UNANTICIPATED DEVELOPMENTS HAVE ALTERED BUDGET PROJECTIONS

Mr. Chairman, the second main area I would like to focus on this morning is to give the committee some indication of what factors in the economic environment have driven the budget in the direction of this huge imbalance that I have discussed, and why all of us—the administration, CBO, and others who made forecasts last year—underestimated the magnitude of the budget problem that we are facing.

The economic outlook, as viewed by practically all analysts early last year at this time, did not anticipate major developments that have dramatically altered the budget projections for the fiscal year 1982–85 period.

These unanticipated developments include the depth and duration of the present recession the rapidly falling rate of inflation that we experienced near the end of last year and that we project into the future; the greater than expected tightening of monetary policy in mid-1981 when we had the severe drought of money growth, and the prospects, therefore, for sharply reduced nominal GNP levels and receipt levels; and the emergence of unprecedented premiums above the inflation trend in nearly all interest rates, and the prospect that these premiums will diminish only slowly over time as monetary and fiscal policy credibility is reestablished.

All of these factors represent economic adjustment forces operating as the economy moves from the condition of excess money and credit growth, uncontrolled Federal spending, rising inflation, and stagnating real growth, to a new era of lower inflation, revived real growth, and monetary, financial, and interest rate equilibrium.

All economic forecasts used last year for budget projections underestimated the severity of these economic adjustments and transition forces that I have just described, and their huge, adverse consequences for the budgetary outlook.

CURRENT ADMINISTRATION BUDGET REESTIMATED WITH EARLY 1981 ECONOMIC FORECASTS

The table that we have provided on page 9 of my prepared statement,[1] compares the current administration deficit projections for 1983 to 1985, that this committee is concerned about, including all proposed budget savings measures, with reestimates of this same budget and this same set of policies based on early 1981 economic assumptions from a variety of sources.

In every case, the deficit projections are dramatically lower because the economic adjustment forces I have just described were not anticipated. And as a result, on an average basis, the changed economic outlook from 1 year ago today has increased the projected deficit by an average of $42 billion in 1982, $59 billion in 1983, and by equal or larger amounts in 1984.

I would call the attention of the committee to page 9 of my prepared statement,[2] and if you look at the 1983 column, I think you can see very clearly what I am driving at here. We are now projecting a $92 billion deficit for 1983. Had the economic assumptions and outlook of last year held up, the deficits would be much smaller under anybody's forecast or anticipation at the time. If you used the Carter economic assumptions of January the 1983 deficit would be $32 billion; if you used ours, $2 billion; if you used DRI's, $46 billion; and if you used CBO's, $52 billion.

But in any case, an increase in the deficit from $40 to $60 billion results from a change in the economic outlook by measuring those forecasts to what we are projected at the present time.

TIMING AND SEVERITY OF RECESSION NOT ANTICIPATED

Mr. Chairman, there are three factors that have caused this dramatic and almost unprecedented change in the budget outlook from one year to the next. All major forecasts of last year, to take the first factor, the recession, assumed that after a few sluggish quarters in calendar year 1981, economic expansion would resume strongly in the fall of 1981 and into 1982.

As a consequence the 1982 nominal GNP growth rate was overestimated by all forecasts by from 50 to 65 percent, and, when combined with higher unemployment, fiscal year 1982 budget receipts and unemployment-related outlays were off by large magnitudes.

If you look at the table I have provided on page 10 of my prepared statement,[3] you can see that on the basis of any of these forecasts, receipts were overestimated by anywhere from $30 to $38 billion for this current fiscal year; outlays by from $6 to $8 billion, and the total deficit by from $36 to $45 billion, simply by not anticipating the recession that occurred.

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[1] See p. 71.

[2] See p. 71.

[3] See p. 72.

GNP GROWTH FORECAST

The second factor that was not fully understood or that was not fully appreciated last year is that after we come out of this recession, there will not be the strong recovery of nominal GNP stimulated by a rapid expansion of money growth that we have had in the recovery period of previous business cycles.

That is because we have brought inflation down dramatically, and we must preserve those gains. I would point out to the committee that 1981 marked a fundamental departure from the previously upward movement of money growth prices, and the inflationary spiral. Growth rates have turned abruptly downward.

On a fourth-quarter-over-fourth-quarter basis, the money supply growth rate declined by 30 percent in 1981, the CPI by 25 percent, and the producer price index by 42 percent. Now, that means that the disinflation process is underway in a substantial and encouraging magnitude, and this is a welcomed improvement for the economy and the American people. But it is a serious challenge to budgetary equilibrium, as I will attempt to demonstrate in a moment.

Unlike the pattern of previous recovery periods, money supply growth must be held in check in 1982, 1983, and 1984, as the recovery moves forward, in order to avoid reigniting the inflationary expectations and upward pressure on prices that we now are in the process of conquering and defeating.

MONETARY LID ON NOMINAL GNP AND RECEIPT GROWTH

This means, very crucially and significantly for the budget outlook, that there will be a monetary lid on the growth rate of nominal GNP and, therefore, on the growth rate of revenues because revenues are generated by the level of nominal GNP and by the level of nominal income in the household and in the business sectors of our economy.

By contrast, during the 1975–78 recovery/recession cycle, money supply growth steadily accelerated in each year after the recession as the recovery gathered steam, rising from 5 percent in 1975, to 6 percent by 1976, and to 8 percent in 1977.

This permitted, of course, an equally rapid recovery of nominal GNP from 8 percent in 1975 to well over 12 percent in 1978. The consequence, of course, was rising prices that badly affected the economy, but also inflation-fueled receipts that disguised the true magnitude of the deficit.

During 1982 to 1985, just the opposite pattern will occur, if anti-inflation monetary policy remains on track. After the anticipated recovery of nominal GNP in 1983, the nominal GNP growth rate will fall, not rise as it has in the past, as inflation is squeezed out of the economy and the lid on money growth is maintained.

This lid on money growth, inflation, and nominal GNP means that there will be no inflation-fueled growth of budget receipts as we have had in the past.

The schematic diagram that we have provided on page 16 of my prepared statement,[1] I believe, demonstrates rather dramatically the budgetary dilemma created by the need to keep inflation coming down, to not revert to the expansionary policies of the past, and to not lose the gains that we have made in bringing inflation under control and returning stability to the purchasing power of our money.

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[1] See p. 78.

The point that I want to make this morning, Mr. Chairman, is simply that this anti-inflation lid on money growth, on nominal GNP, and on budgetary receipts was not accurately reflected in any of the early 1981 forecasts, including that of the administration.

In combination with a failure to predict a much lower 1982 recession level of GNP, this means that 1983–85 nominal GNP levels and budget receipts were dramatically overestimated by each and every forecast.

MAGNITUDE OF GNP AND RECEIPT OVERESTIMATE

I think if you look on page 18 of my prepared statement,[1] you can see the dramatic picture that I am attempting to highlight here this morning. For fiscal year 1983, the budget year that your committee will be contending with, on any forecast that you look at from last year, nominal GNP was overestimated by anywhere from $139 to $198 billion. By 1985, that overestimate rises to between $242 billion and $467 billion. Of course, the implication for receipts is huge.

Because nominal GNP will be lower due to the recession, due to lower inflation, due to the lid on economic expansion, and due to monetary policy, receipts will be anywhere from $51 to $60 billion lower in fiscal year 1983 than any forecasters anticipated last year, including CBO, ourselves, and DRI, and they will be anywhere from $60 to $106 billion lower by 1985, the third year of your resolution. Last year we overestimated receipts by $201 billion for 1982 to 1985 and CBO overestimated by $206 billion for the same period.

The third factor that has changed, Mr. Chairman, and members of the committee, is that——

Senator **Boschwitz**. What were those two figures?

Mr. **Stockman**. Those figures are $201 billion in lower receipts for fiscal years 1982 to 1985, compared to what we estimated last year, and $206 billion lower if you use the economic assumptions of CBO.

INTEREST PREMIUMS AND FINANCIAL MARKET TRANSITION

The third factor that has changed, of course, is the sudden and abrupt development in the financial markets of a large premium. You can call it an inflation premium, a volatility premium, an uncertainty premium, a risk premium, or whatever. But, clearly, it exhibits a fundamental departure from the experience of the past and any experience that we could reasonably project into the future.

Throughout the 1970's, the rise of the interest rate just paralleled or tracked the rising level of inflation on an annual basis. Indeed, in the T-bill market, the average real interest rate was actually negative most of the time, as we indicate in the chart on page 21 of my prepared statement,[1] meaning that for a good part of the decade, the Federal debt was financed at a negative rate of return—a bargain to the Government, but not to investors.

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[1] See p. 18.

But as the inflation and financial disorder worsened in 1979 and 1980, the financial markets adjusted and caught up. Long-term lending dried up, and huge premiums above the inflation rate appeared in securities throughout the maturity spectrum. These premiums reached unprecedented size in 1981.

If you examine that chart, you will see how this historic linkage or relationship changed dramatically and we were suddenly confronted with 4- and 6-percentage point differentials in 1981 between the inflation rate and the T-bill rate at which we finance the debt.

Forecasts issued in 1981, including the administration forecast, generally did not anticipate the size of these premiums, nor did they anticipate that they would persist over an extended duration as we now believe. As a result, interest rates were seriously underestimated and interest-related outlays were underestimated as well.

It now appears that interest rate premiums will remain sticky during the transition to lower inflation. While progress in reducing interest rates can be expected as inflation falls, it will take time to restore long-term financial confidence, refinance short-term business and household liabilities, and bring credit demands, including Government demands, and availability into balance.

As a consequence, the administration's current forecast assumes substantially larger interest rate premiums over the next several years than did almost all forecasts of 1 year ago. Rather than the traditional 1 to 2 percent, we are now suggesting something like 4 percent or greater for the next 3 years.

Now, as the inflation rate improves, that means the interest rate can come down, but with that higher premium during this transition period, it will not come down nearly as much as we projected last year. As a consequence, interest related outlays will be $8 billion higher in fiscal year 1982 and $54 billion higher over 1983–85.

Now, the final point—and I think this is important to stress—is that any error in the forecast that results in lower receipts or higher unemployment or higher interest rate related outlays will have one fundamental effect, and that is to increase the deficit and to add to the debt that we must finance during the current year and in subsequent years.

If you take all of the forecasts that I have discussed here this morning and bring them down to the bottom line—the added debt that results from these changes in the economic outlook—you can see the enormous effect that debt has had on the budget.

When all forecast factors are reduced to this bottom line—added deficit and increased future year debt—the conclusion is the same. Debt service outlays due to larger deficits will be substantially higher even if the administration's complete budget savings program is adopted.

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[1] See p. 83.

OUTLAY INCREASE DUE TO ADDED DEBT

On page 25 of my prepared statement,[1] I try to isolate the increase in outlays, and therefore deficits, that will result solely from higher debt to finance during the 1983 to 1985 period as a result of these changes in the economic outlook. Again, as you can see, the range is $24 to $53 billion. The CBO was the closest, we were the furthest away, but in each case these changes in all forecast factors have added substantially to the fiscal burden that we now face.

IMPACT OF ECONOMIC TRANSITION ON BUDGET OUTLOOK

Mr. Chairman and members of the committee, let me sum up this part of the presentation by making the following observation about why the budget picture that we are projecting has changed and how these economic factors that I have described generally affect it.

The more abrupt than expected slowdown in money growth between 1980 and 1981—7.2 percent in 1980, compared to 4.9 percent in 1981—in the context of accumulated financial weakness and depressed long-term capital markets, tripped the economy into a temporary recession and correction of underlying financial and economic imbalances.

The resulting higher interest rates and borrowing have added $17 billion to the 1982 outlays. The resulting recession has further reduced receipts by $31 billion from what we anticipated last year, and raised unemployment-related oulays by $8 billion.

This total change, $57 billion, driven by economic forces accounts for the entire increase in the 1982 deficit from the original projections. In addition, this will make it that much more difficult to reduce the deficit in the out-years because of the deep hole in which we begin.

Second, as the recovery gathers force through 1983 and 1984, the anti-inflation monetary policy will impose a lid on the recovery of nominal GNP and budget receipts, as I have explained. Thus, the budget receipt projection has been substantially reduced since last year. It is $53 billion lower on our forecast now for 1983, and $170 billion lower over the 1983 to 1985 period.

As a consequence, inherited or new spending commitments cannot be financed with inflation-fueled growth of receipts during the recovery period, as has been the practice and as has been the case in previous business cycles, 1975–78 being the most recent.

The recession-induced rise of unemployment to the 9 percent range some time this spring will add further pressure to the budget, even as the unemployment rate drops over the next several years. As a consequence, safety-net-related or unemployment-related outlays will be $14.1 billion higher over fiscal year 1983 to 1985 than we anticipated last year.

As I have indicated before, the restoration of financial market confidence and stability will take more time than previously anticipated, and this too will increase outlays for interest and debt service.

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[1] See p. 87.

We are now projecting an average T-bill rate 260 basis points higher than our projection for 1983 last year, and that adds, just on the interest-rate-related accounts alone, $15 billion in 1983 and $54 billion over the 3-year period.

When you sum all of these factors together—higher interest, more debt, and more debt to finance—it adds $106.9 billion over the 3 years of your budget resolution.

EFFECTS ON BUDGET OF CHANGES IN ECONOMIC ASSUMPTIONS

The huge differences in budget and deficit estimates shown in the table on page 31 of my prepared statement,[1] are due to changes in the economic outlook since last year, and as I have indicated, they are not unique to the administration's forecast of last February, but are common to all of the forecasts that occurred at that period.

I now want to call to the attention of this committee something that worries me greatly, and that is that if we cannot act this year to solve this deficit problem, we could unleash a vicious cycle of rising deficits, increasing debt, higher interest rates, and rising outlays to finance that higher debt as it accumulates each and every year.

POTENTIAL EXPLOSION OF DEBT SERVICES COSTS

In my prepared statement on page 33,[2] I have tried to give you a dramatic illustration of what is happening to net interest costs in the budget and interest on the debt, and what could happen if we do not take action to bring down the deficit this year and in future years.

As I have indicated, the increased interest rates and debt financing requirements for 1983 to 1985, compared to what we projected last year, add $106.9 billion to the deficit and outlay projection since last February.

But if we take no action this year on the fiscal year 1983 budget savings program or something that you would propose, net interest outlays will rise another $33 billion by the higher deficit that would result from growing current services. And if economic performance then weakens under those $160 billion deficits during the recovery period, we will add even further to the deficit and add even further to debt service costs—another $37 billion over the 3-year period.

What I am saying very simply, members of the committee, is that the cost of no action on the budget this year for 1983 to 1985 could add at least $70 billion to our problem that would simply accumulate as we sat on our hands and the deficit swelled, the national debt increased, and the interest rate pressure continued.

That indicates that the cost of no action is $70 billion, to say nothing of the cost to our private economy and our hopes for economy recovery.

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[1] See p. 93.

[2] See p. 95.

CBO VERSUS ADMINISTRATION ASSUMPTIONS

Now, in my concluding remarks here, Mr. Chairman, I want to make just a couple of points about the relationship of our forecast this year, which I believe makes an effort to incorporate some of these things that were not anticipated or seen last year, relative to what CBO is projecting at the present time.

It should be clear from the foregoing that the major factor that drives the deficit and the major factor that shapes the budget by way of economic assumption is nominal GNP. That is what drives revenues, and that is what shapes the budget in this current disinflationary environment that we are in.

I am happy to report to the committee this morning, as we demonstrate on page 38 of my prepared statement,[1] that the nominal GNP forecast and the receipt forecast of the administration are almost identical for 1983 and 1984, with a very small difference in 1985. Now, that is on economic assumptions; there are some differences on technical estimates.

The next point I would make is that there is a significant difference in terms of budgetary impact in the composition of nominal GNP on which we are agreed. Here, of course, I am referring to the split of nominal GNP between real growth and the GNP deflator, or inflation.

Essentially, CBO assumes a significantly lower real growth rate over the 1983-85 recovery period, and a higher inflation rate. I have tried to provide here some background information and historical statistics for the committee to evaluate the differences between what we are projecting and what CBO is projecting relative to previous recovery periods.

We are projecting an average real growth rate of 5.4 percent from the second half of 1982 through the entire calendar year of 1983—the first six quarters of recovery. CBO is projecting 4.5 percent, somewhat lower. You can compare, then, either of those assumptions with the recovery growth rate we have had during the first six quarters in 1975-76, 1970-71, and previous business cycle recoveries.

Basically, our growth rate is slightly below the historic average for all post-war recoveries of 5.6 percent, and CBO's is somewhat more below.

The second factor to look at is not simply the initial stages of the recovery, but how long it will be sustained and what the growth rate will be over time as you move out into 1984 and 1985, which are also the period of your budget resolution.

Basically, we are projecting that for the 22 quarters beginning in mid-1982 out through 1987—the budget projection period that we use—there will be a growth rate of 4.7 percent, compared to 3.1 percent for CBO, an average of 3.5 percent over the post-war period, and an average of 5.4 percent during the high-growth period of the early 1960's.

So, we are projecting growth above the post-war average, but below the strong growth of the early 1960's. We provide in my statement some further comparative information for the committee to evaluate the validity and the plausibility of those assumptions.

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[1] See p. 100.

FORECASTS DIFFER ON INTEREST RATES

The difference in the forecast is on the interest rate. Here, we have roughly the same inflation premium, or premium above inflation, but CBO has a higher inflation rate. So, therefore, when you add the two together, their T-bill rate assumed is significantly higher than ours in 1983, with the difference diminishing quite drastically in 1984 and 1985, where the difference is less than 100 basis points.

Now, the overall impact of these differences in purely economic assumptions—and I am not bringing here into the discussion technical estimates about defense outlays or CCC, and so forth—but if you take our budget and reestimate it with the CBO assumptions that were published in early February, then the total impact on the deficit is shown on page 43 of my prepared statement.[1]

That impact, of course, would be to increase the deficit, through all of these factor differences, by $5.9 billion in 1982, by $7.3 billion in 1983, and by larger amounts, rising to $21.8 and $31.8 billion in 1984 and 1985, respectively, as these differences compound through the economic performance levels and the degree of deficit to be financed.

Now, I present this for the information of the committee so that you are in a better position to evaluate where the deficit will be and the problem that you are coping with as you look at the range of economic assumptions under which it can be estimated.

But there is one important point that I would like to make in closing here, Mr. Chairman and members of the committee, and that is simply that these differences are significant, and you will have to make the judgment as to what is the more plausible path and what is the more reasonable set of assumptions.

But even as you do that, remember that that is a small part of the problem relative to the size of the policy action that is needed to even get to these deficits, whether with CBO assumptions or ours; I have provided both estimates on page 43 of my prepared statement.[2]

DIFFERENCES IN FORECASTS THIS YEAR ARE MUCH NARROWER

On page 44 of my prepared statement,[3] I indicate that the cumulative difference between the CBO and the administration forecast for your budget resolution period is $61 billion. If you use the CBO economic assumptions, the deficit would be $61 billion higher over 3 years, with the major difference being in 1985.

On the other hand, our budget savings plan, the policy action that we have submitted to this Congress, amounts to $239 billion over the same 3-year time period. So, therefore, the estimating differences by way of the forecast are only 25 percent of the huge change in the deficit that we can achieve and will achieve if we can implement policy actions to reduce it.

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[1] See p. 105.
[2] See p. 105.
[3] See p. 106.

My point, Mr. Chairman, is that the differences in the forecasts this year are much narrower than last year; that factors have emerged that we did not anticipate and that we understand better now, and that we have tried to incorporate into our budget forecast.

But all of those things having been said and done, they shape the climate that we now deal in; they shape the numbers that we must now contend with. And whatever remaining differences are in the economic forecasts are substantially overshadowed by the magnitude of the policy action needed on revenues, on entitlements, on discretionary programs, and on management initiatives of all kinds to bring the deficit into a path that is minimally tolerable and minimally compatible with our desire to move forward with the restoration of economic growth and a continuation of our success on inflation.

So, those are my opening comments to the committee, and I appreciate very much this chance to meet with you and to try to respond to your questions as well as I possibly can.

Senator ARMSTRONG. Thank you, Mr. Stockman.

For those who have arrived in the last few minutes, the chairman has asked that I recognize members of the committee in accordance with the early bird rule, and it is also my understanding that we will be under the 5-minute rule.

Senator Hollings?

OPENING STATEMENT OF SENATOR HOLLINGS

Senator HOLLINGS. Mr. Stockman, the temptation obviously is great to question you about past events. I have got a lot of clever questions and you, I am sure, have got a lot of clever answers. We could discuss the statement that you made about the long-expected recession. Well, you and I know the contrary is true. Last February you predicted that if you got your program, you would have a 4.2-percent growth rate in the last quarter of 1981.

So, it was not a long-expected recession; it was the long-expected consequences of your program. You also mentioned that all forecasters failed to anticipate that reaction. Well, we can go to the record—the staff has got it here—where we did anticipate this kind of dilemma, and prove who is right and who is wrong.

ALTERNATIVE PROPOSAL

But we need to focus on the current situation. You have said that no serious alternative has been made to the President's budget. But, we have the majority leader and the majority whip in the Senate considering my alternative proposal in a serious fashion. We have had good colleagues on both sides of the aisle here on this Budget Committee consider it seriously.

But for you to come forward and say there is just no other proposal is not helpful at all. We have got to reduce this competitiveness of who can make the best TV appearance and get on the 7 o'clock news, and see if we can work together.

My plea to you is for us to get on with devising a solution. In order to do it, we do not have to get rid of the Reagan program; that is not my point. The truth of the matter is, we all believe in supply side. The Kennedy tax cuts were the previous version of it. So supply side programs are nothing new.

TAX CUTS

I co-sponsored with Senator Domenici the spending cuts last year. I went along with the increases in defense. The problem, of course, was that outrageous tax cut that now has the ox cart stuck in the ditch.

You have got to disabuse yourself from the idea that you invented tax cuts. Please tell President Reagan that we have had seven tax cuts in the last 10 years; we lost over a trillion dollars in revenues in the decade of the seventies. We all love tax cuts.

You have got to disabuse yourself from the idea that if you withdraw the resources from Government, that will force us to cut spending. Among your own leadership, Senator Stafford on the Education and Labor Committee says no more cuts in education; Senator Dole this morning said no more cuts in food stamps. So, you are not forcing spending cuts.

INTEREST RATES

You and I could think of some cuts that we could vote for, but that is politically unrealistic. You have got to disabuse yourself of the idea that high taxes are the worst evil. High interest rates are an even greater evil, as you show in your chart on page 31 of your prepared statement.[1]

You and I and everybody working together cut spending $35 billion last year; we canceled out about $23 billion of it through increased interest costs. Your proposal right now before this Congress is to spend nearly $100 billion that we do not have.

We are going to have to work in a bipartisan fashion to fix the mess we are in. It is just good Democratic politics. I think the Achilles heel of us Democrats is that we do not have credibility on fiscal matters. We can help lead the way—and I would plead to my Democratic friends to help us lead the way in the search for an alternative.

"PUT UP OR SHUT UP"

I like President Reagan's politics when he says, "put up or shut up." I think we ought to put up. If we do not get a bipartisan solution to this problem, and quick, you will have the paralysis that you are talking about. You say that if we sit on our hands and do nothing, the deficit will go up, up and away. That is exactly what is worrying me.

But you are leading the way for that kind of paralysis, because we are not in a poker game. I see you playing a very sharp game of poker saying, "we will not give on this," and maybe at the last minute, "we will give on that." But, events could overtake us by then.

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[1] See p. 93.

We are going to be voting on the debt limit bill later this spring. You are going to have a lot of people cementing their positions by then. If that happens, you and I are not going to be able to negotiate in June, July, and August, to patch this up and get it all together. Then we will be locked into election politics.

So there could well be that paralysis, and next year at this time, we will have locked in the high interest rates, we will have stagflation, and we will have conditions similar to England. I am very much worried about that, and everyone is worried about that.

ELIMINATE TAX CUTS

The first order of business is to find some alternative to the President's plan. I say do away with the tax cuts. But I would not do away with the President's main supply side program of business tax cuts, or the 5 percent already in place. We could always pick up the tax cuts later. In fact, in 1984 if we can get the interest rates down, I might take the lead for a tax cut. A team of horses could not hold us back. That will be a good election year to come back for a 10-percent cut. But right now we have got to get the interest rates down.

Senator Baker's alternative will save the President's program, as he sees it. He would have a surtax; it will pick up the same $40 billion. Fine; that suits us. But you need those kinds of major changes.

FREEZE DEFENSE SPENDING TEMPORARILY

When you get to defense, I said a temporary freeze, because I know this defense budget by heart. You have $33 billion in unobligated balances. If President Reagan gets his defense budget for 1983, you will have $43.1 billion in unobligated balances.

Now, your Secretary of Defense is roving the world like Palladin—"have gun, will travel." He has not given us yet the 5-year procurement annex. Rather than the Government going out in January to borrow money in the market, they ought to go over to the Pentagon—they have got plenty hanging around—and borrow from them. [Laughter.]

What I am saying is we need time rather than money. Given the defense budget, the $24 billion we increased it last year and the $31 billion the President requested this year—that is $55 billion that we could, in an orderly fashion, phase in over 36 months, rather than 24. We could get that 5-year procurement annex, and then, move into a good defense budget that we all can support.

FREEZE ENTITLEMENTS

Similarly, with entitlements. My plan would not freeze entitlements for 6 years, or whatever it was you said in one statement over on the House side. Number 1, we have to save social security. Dr. Rivlin and the CBO tell us that the last check could go out as early as October of 1983, even with the interfund borrowing. We are going to have to have some kind of freeze.

Entitlements mean just those things you are entitled to, by law. We did not start automatic COLA's until 1975. Ninety percent of those on retirement never heard of a COLA when they were paying into the retirement fund and they were not entitled to it. One hundred percent are not entitled to it because they never paid for it. We are having to borrow money to pay for the COLA.

ADJUST AND BE FAIR TO ALL

Let us be fair to all. The character and the spirit of our approach is for a sharing of the necessary sacrifice, because if we do not get some big reductions, then saving only $40 to $50 billion will not really repair the damage.

I could not vote for it, and no one else is going to vote for it. Certainly, they are not going to vote for cutting $25 billion in spending only to end up with $100 billion in deficits.

So we ought to start negotiating now and seeing how we can package a budget plan and get support.

If we can do that in a bipartisan fashion, I am willing to work with you because I think it is too serious a situation for us to just make headlines. We have got to start making some headway on this problem. Otherwise we may not be able to get a budget resolution.

I am very, very worried that we cannot even get a majority to vote for these high deficits; they should not. So, let us get a high-deficit solution of some kind and work in a bipartisan fashion.

Thank you, Mr. Chairman. I have a prepared statement. I won't read it, but will ask it be inserted in the record.

Senator Armstrong. Thank you, Senator Hollings.

PREPARED STATEMENT OF SENATOR HOLLINGS

We welcome you here this morning, Mr. Stockman, for a frank exchange of ideas on what the Fiscal 1983 budget will look like.

All of us know how the President originally reacted to criticism of his budget. "Put up or shut up," he said. Beyond that, he suggested that Congress would see the light on his budget once we returned from being home with the voters. As it has turned out, the President has gotten his wish on both subjects.

On the day after the President "requested" alternative proposals in his speech before the Indiana State Legislature, I proposed a plan which could bring us a balanced budget by Fiscal 1985. Within hours, it was dismissed by the Administration. Within days, you told the House Budget Committee the plan was not realistic. But now Congress has had a week back home to listen to what the public is thinking. What we heard at home, matched to the reception given alternate plans -- including my own -- both in the Congress and "fifty miles outside Washington," make it clear that the budget we approve late this summer will not be the budget proposed by the President in February.

It would be a glaring mistake for the Administration to so stubbornly cling to theoretical purity that it refuses to consider workable alternatives. The White House must understand that given the flaws in its current budget offering, it cannot ignore alternatives until "pigs get wings." Members of your own party are already seeing "pork in the treetops." Congress needs the reasonable cooperation of the White House to wring out the gigantic deficit in a fair and practical way. While I do not insist that my proposal is the only way to do that, it is a plan widely perceived to have merit. I think it needs to be briefly reviewed here this morning.

If it is approved by the Congress, it could slash the deficit to $52 billion in Fiscal 1983, reduce it to $24 billion in Fiscal 1984, and balance the budget by Fiscal 1985. It is not necessarily a departure from the overall Reagan approach, but rather a practical attempt to rescue the Reagan program from its own excesses. My alternative is not painless, but it is fair, containing neither special preference nor inflicting unreasonable burdens on targeted segments of the economy.

First, it would defer the increase in defense spending proposed for Fiscal 1983 in the Reagan budget, and permit three percent real growth in Fiscal 1984 and 1985. If approved, it will bring savings of $76 billion by Fiscal 1985. It in no way signals a retreat from the idea of a strong defense. If anything, it underscores the fact that we are serious about the strength of our armed forces and equally serious about strengthening our economy to produce what we need in the defense sector.

Second, we can defer the cost-of-living (COLA) adjustments under our entitlement programs. There can be no doubt that social security, for example, faces a troubled future. But we will serve neither the social security system nor the social security beneficiaries if we permit an inflated economy to trigger automatice increases that further threaten the well-being of both. Automatic adjustments of social security did not become a regular feature of the program until 1975. Before that, there was no automatic pilot approach to cost-of-living increases. If we freeze the COLA for one year while developing reforms under social security and other entitlement programs, we can save $88 billion by Fiscal 1985. The idea is not to single out or penalize retirees for the size of the federal deficit, but rather to insure that retirement programs survive the horrible budget deficits predicted under the Reagan budget.

Third, we need to forgo the July 1982 tax cut, and reduce the July 1983 tax cut from ten percent to five percent. If that is done, we could save $8 billion in Fiscal 1982, $35 billion in Fiscal 1983, $49 billion in Fiscal 1984, and $64 billion in Fiscal 1985. The Kemp-Roth notion of massive tax reductions has caused all of Ronald Reagan's good intentions to come undone by the burgeoning deficits he had pledged to erase. Despite the gymnastics of the President's Council of Economic Advisers to downplay the importance of the deficit, those deficits are crippling and must be eliminated.

If we approve the plan I have offered, achieve half the Administration management savings, and forgo the 1983 government pay raise, we can, with attendant savings from lower deficits and interest rates, balance the federal budget by Fiscal 1985. And we can do it without further program spending cuts.

The plan I propose, together with alternate plans offered by other memebers of the Senate, do not constitute a massive rejection of the Reagan idea of less government and less government spending. Nor do they contain some hidden accounting alchemy. The numbers I have used this morning in describing my alternative proposal come from the Congressional Budget Office. My proposal is simply intended to reach the goal the Administration has chosen to defer, i.e., a balanced budget.

You told the House Budget Committee when you testified before them, that you were skeptical of my plan because, in your words, "it was developed in a few days." You defended the Reagan plan because it was developed over a long period of time. If it took all that time and still produced a $91.5 billion deficit for Fiscal 1983, I don't think I would be waving your proposal around as an example of the talents of your economic varsity.

We need to work together. It is much easier to open doors than to build walls between the White House and Congress. We need, most of all, to set our course with a practical plan that can achieve what we all want, a healthy and vigorous economy. I hope that you, and the President, and the rest of the Administration will join the Congress in that effort.

HOLLINGS BUDGET PLAN

	($ in billions) FY 82	FY 83	FY 84	FY 85
BASELINE REVENUES 1/	631	652	701	763
BASELINE OUTLAYS 1/	740	809	889	971
BASELINE DEFICITS 1/	109	157	188	208
DEFICIT REDUCTION MEASURES				
REVENUE CHANGES				
Forgo July 82 10% tax cut Reduce July 83 10% tax cut to 5% Repeal indexing	8	35	49	64
Repeal leasing	1	3	4	6
TOTAL REVENUE CHANGES	9	38	53	70
SPENDING CHANGES				
Cost-of-living adjustment (COLA) freeze --1 year--and reform 2/	4	19	28	37
Forgo 83 government employee pay raise.	--	6	6	7
Defense spending freeze--83--3% real growth in 84-85	--	20	30	26
Management savings--half of Administration proposals 3/	--	10	12	12
Interest savings from lower deficits and interest rates. 4/	1	12	35	56
TOTAL SPENDING CHANGES 5/	5	67	111	138
TOTAL DEFICIT REDUCTION	14	105	164	208
DEFICIT/SURPLUS	-95	-52	-24	0

February 18, 1982

Senator ARMSTRONG. Senator Symms?

REDUCE SPENDING TO TAKE PRESSURE OFF CREDIT MARKETS

Senator SYMMS. Thank you very much, Mr. Chairman.

Thank you for your excellent testimony, Mr. Stockman. I think Senator Hollings made the point that there is a great deal of concern about these big deficits and how they are impacting the financial markets. So, when we start looking for solutions on how to reduce spending to take the pressure off the credit markets, one way would be to cut defense spending; another way would be to talk about the entitlement programs and have some substantial reform in entitlements which could last for several years.

Which one of these ways do you think would have the most impact on the financial markets?

Mr. STOCKMAN. Senator Symms, I am not sure that where you take the money from has any special impact on the financial markets. I think the concern of the financial markets is how much you are borrowing both currently and prospectively.

If you can demonstrate in some persuasive way that you have things under control and that that borrowing requirement is coming down so that the savings of the economy are available for private investment and so that the enormous pressures and uncertainties generated in the financial markets can abate, then it really does not matter where you take it from on that score.

However, you do not do things in a vacuum. As you decide where to get that money from—and that was what we had to struggle with for 3 months—we had to look at our other policy objectives on defense and in a whole variety of areas, and that is the real task that you have before you.

Senator SYMMS. If you put on a cap and froze entitlements, and did it for a period of years, would that not accumulate a lot of savings? If we try to delay defense spending, we just end up needing to play more catch-up next year. Is there a point to that?

Mr. STOCKMAN. Yes. I think it depends on what you do in the outyears as well as in the current year. If you undertake actions that will tend to lower the growth of the budget——

COLA REFORM

Senator SYMMS. I just returned from 10 days in Idaho, and had several people stand up at town meetings and tell me they are earning as much money now on retirement as they did when they were actually working because of the COLA's. Some of the people said they have had an 80 percent increase or 90-percent increase since 1975.

In the case of one retired military colonel, he said he was making more money now as a retired citizen than he made as a full colonel. He said, "I fought in three wars. Why are you trying to continually save this country, and now you are bankrupting it by giving me all these increases?"

So, why are we not attacking that?

Mr. STOCKMAN. Well, Mr. Symms, we have quite a major and controversial COLA reform proposal for both military and civilian retirement in the budget that would reduce the cost of military COLA's by $536 million between 1983 and 1985.

Senator SYMMS. I am talking about all COLA's, all entitlements. Is it not going to take that kind of drastic action to send a signal to the financial markets?

Mr. STOCKMAN. I think it well may, but you cannot send a signal unless you have a bipartisan consensus to do it. And it seems to me that in that area, we need to go back to Senator Hollings' words and his suggestions and invitation, and see what can be done.

But there is no point in talking about it or adding up a lot of numbers unless there is a bipartisan consensus to address that issue.

ANALYZE TAX INCREASES FOR IMPACTS IN OTHER AREAS

Senator SYMMS. Senator Hollings also brought up the point about tax increases, or stopping tax reductions that we have passed. Is it not true that if we try to raise taxes, the corporations and financial institutions and private individuals will be pressured into the credit markets to borrow money because of the illiquid condition that the private sector is in?

The pressure will still be upward. The answer is that we have to cut spending more.

Mr. STOCKMAN. Well, I think, generally, I would agree with that proposition. It seems to me that as we look for these big solutions, the big formula, the large increment, we have to remember that everything we do affects something else, and if we simply try to solve it in one area, we may create problems elsewhere economically, or for our national security or in terms of meeting minimal requirements of some people who are on fixed Government benefits, which we have to be careful about.

So, I think that to anybody struggling with this problem, the big formula sounds like the way to get it done legislatively and politically. But as we work on that big formula, whether it is COLA freezes or anything else being talked about here, it has got to be analyzed carefully for the impacts that it has and for the unexpected consequences that it has, and shaped accordingly.

I would just suggest that we spent 3 months struggling with some of those factors, and I hope that as these alternatives appear on the Hill, there will be the same kind of scrutiny given to what is being proposed.

CONSTITUTIONAL AMENDMENT MANDATING A BALANCED BUDGET

Senator SYMMS. Well, I think that Senator Hollings made a very good point about the fact that we do have staring us in the face the necessity to borrow more money to continue to run the Government.

Now, I had a lot of people tell me, "We are being laid off in the private sector; lay off more of the Government to make it equal with the private sector." They do not want us to borrow any more money.

Maybe now is the time for us to pass a constitutional amendment mandating a balanced budget, with a tax limitation, so that the financial markets would know that this Congress is going to get this job done by 1984 or 1985.

Mr. STOCKMAN. Well, Mr. Symms, I would not suggest that a constitutional amendment would be unhelpful. But I would suggest that this problem is so immediate and urgent—and it requires action in the next 2 or 3 months—that we had better focus all of our efforts and all of our political and intellectual resources on getting that problem addressed.

Senator SYMMS. I think Senator Hollings makes a good point, though, that the issue is coming, and it is coming in April or May when there is a necessity for borrowing more money. I think that there are a lot of Senators that I talk to that feel like I do. I want major reforms in our spending policies, and I want to put the appetite of this Government on a major diet, with the priorities being emphasized in the entitlement area, which is literally bankrupting the Government and the country.

The debt ceiling may be the issue that has to be focused on, and then maybe we can do it all at once.

I think my time is up, Mr. Chairman.

Mr. STOCKMAN. Well, Mr. Symms, let me only suggest that, on the occasion of the debt ceiling coming down the road, if you are going to hang extraneous matter on it, do not hang that extraneous matter on the Constitution; hang that extraneous matter on the fiscal year 1983 and fiscal year 1984 budget, and help us get it down, because if we do not address that urgent, immediate problem now, the constitutional amendment will not make much difference later.

Senator SYMMS. Thank you.

Senator ARMSTRONG. Thank you, Senator Symms.

Senator Chiles?

OPENING STATEMENT OF SENATOR CHILES

Senator CHILES. I, along with some of the other members of this committee, went to a breakfast this morning held by the Committee for a Responsible Federal Budget; that is Bob Giaimo's and Henry Bellmon's committee. We listened to a number of the country's financial leaders who were there, and it was interesting to me to hear what I think was a consensus there, combined with what I have been seeing in the paper, that basically business leaders are saying we are going to have to do something on the revenue side to reduce the deficit.

BIPARTISAN PLAN SUGGESTED

They were talking about whether we should hold back the third year of the tax cut, or whether we should do something else on the revenue side. But there seems to be a strong feeling on the business leaders' parts that unless we do something quickly through the budget process, we really can have a financial disaster on our hands in this country.

Of course, they were calling on us to come forward with a bipartisan plan; you have mentioned the same thing Mr. Stockman. The question is, what are the components of a real bipartisan plan?

Now, from our perspective, looking at the size of the deficits facing us over the next 3 years, there is no way you are going to make an appreciable difference in the deficit by just hitting the spending side, especially if you exempt defense from cuts. There is also no way that you are going to make that appreciable difference along with something on the revenue side, along with something in defense, and something in the entitlement programs.

Now, if we are talking about a bipartisan consensus which, the Democrats join, and we must have the democrats agree, then we are talking about Democrats cutting entitlement programs and Democrats cutting defense, while the President continues to say that certain items are not negotiable: the tax cut is non-negotiable; the defense increase is non-negotiable.

I do not know how you are going to get that kind of consensus in light of what the President is saying. Even if we begin it here in this committee, and I think we will, regardless of what action the President takes, it will not go beyond this committee. It will not have a chance to fly on the floor of the Senate, let alone the floor of the House, unless we can reach a broad consensus.

I think you are going to have to have the people brought into this at some stage. Right now, it is interesting to me that there is a consensus forming with the financial leaders of this country that we have to do something. They are the very people that a year ago were saying we had to pass the President's program, and they were the greatest force behind getting it passed. I can see all of their buttons as they walked into my office now, and all of the tags that they wore—the bankers and the insurance people.

Those very people are now saying, "Cut defense, raise taxes, but for goodness sakes, do something about the hemorrhage of deficits out there, or everything is going to come tumbling down."

Now, they are saying that, but as I go around Florida, I still hear a lot of people in my State saying, "What time will the recovery start? Will it be in the second quarter or will it be in the third quarter, and how strong is it going to be?" That is what they have heard from the President and he is the best communicator of all.

VIABLE ECONOMY NEEDED TO MAINTAIN PROGRAMS

So, you have the financial leadership reversing itself on the one hand, and the Congress now ready to come together to do something on a bipartisan basis, but there is one player missing. That is the chief, the communicator. And unless we get the communicator into this act and unless we tell the people what the problems are, and unless we have some kind of an economic summit where you bring together the leaders of the financial community, the Federal Reserves, the leaders of labor, political leaders from both sides of the aisle in the Congress, and the President to convince people we are in a situation where everything has to be looked at—the only way we are going to have the strong defense we all want is to have a strong, stable economy.

The only way that we are going to maintain entitlement programs, social security, and these other programs is to have a healthy economy. So, we have to look at all items, including the tax cut. But our time is running short. As the Senator from South

Carolina said, we will be in partisan politics before very long, and unless we get the communicator on board in this and unless the President is willing to join in this kind of meeting, then I do not see how in the world we will regain a stable economy.

All of us sit here knowing what needs to be done, watching the abyss come closer and closer as time runs out, and yet we are still told that two of the major items are nonnegotiable, defense and entitlements. We have a situation now where the clock is frantically ticking, and unless we make these items negotiable, we will not have any chance of really doing something to repair our economy.

NO FUNDAMENTAL RETREAT ON PRESIDENT'S PROGRAM

Mr. STOCKMAN. Mr. Chiles, let me respond with a couple of points. I appreciate your advice and I think some things were well taken, but I would dispel the notion that somehow we have said certain things are nonnegotiable in some absolute, rigid sense.

What the President has said is that there cannot be any fundamental retreat on his basic tax program and on the clear and undeniable need to rebuild the defense capability of this country.

Now, if you look at our budget, which people have not looked at in detail, we have clearly recognized the need to raise additional revenues; perhaps not in the magnitude that Senator Hollings or you feel appropriate or in the right mix, given all of the other things that we have proposed, there is about $32.2 billion worth of additional revenue in the 1983 and 1984 budget as a result of things we have proposed—the corporate minimum tax, the closing of various loopholes, the accelerated collections of the corporate tax, and so forth.

So, to say that it is nonnegotiable, I think, is wrong. What the President said is, no fundamental retreat on the heart of his program, which was the business tax incentives that everybody has endorsed here this morning, and the basic rate cut for individuals that was long overdue.

So, let us not overdramatize what is available for discussion and what is not. Let me also say that to suggest that somehow the President is not onboard and that he has not done his part in terms of recommending action that this Congress can consider on this common problem that we face, I think is a disservice and is inaccurate.

You may not like this budget; you may not like the deficits. You may disagree with the change in food stamps or the change in the higher education program, or whatever the case may be. But I would urge you to look carefully at it, because in it you are going to find many things that you can support and many things you can agree with.

And as much as we would like to have one formula that will solve all these problems, I can guarantee you that it is going to take dozens and dozens of steps on the spending side, on the management side, and on the revenue side to put a package together that will close the deficit gap to a degree that is tolerable.

SOME ADMINISTRATION PROPOSALS

Now, look at some of the things that we have proposed: $2 billion worth of savings by tightening provider reimbursement in the medicare program. Maybe some of these are not viable and you will reject them, but there are many things in that package which I think members of this committee could easily support under the economic and budget circumstances that we are in today.

Lowering the physician screen from 8 to 5 percent; on an interim basis, reducing the hospital reimbursement rate that got totally out of hand last year; making changes so that hospital-based physicians are paid like all the rest of them—these kinds of things are not glorious and dramatic. They do not add up to $50 billion or even $10 billion, but it is the $100 million and $300 million savings that we will need in dozens of areas that help solve this problem.

So, take a look at what the President has proposed in detail, in all five areas, and then decide what additional or what different things you want to do, but do not make the suggestion that we have simply allowed the problem to fester and that we have not proposed anything that is doable, justified, or right to help deal with it. That is the only thing I would suggest this morning.

HIGH DEFICITS CAUSING PROBLEMS

Senator CHILES. You are again misinterpreting my words. What I am taking a look at is a $112 billion deficit in 1982, under the best of circumstances—and it could be higher depending on who is doing the estimating—to a $140 billion deficit in 1985 under the President's program.

I am taking a look at a Congress who gave the President everything he asked for last year, and now we are talking about trying to do something to reduce those deficit numbers. That $112 billion growing to $140 billion is what is causing the high interest rates.

As we talk about getting together on a bipartisan basis in the Congress, we are faced with the fact that tax cuts and defense are nonnegotiable. That is what I am talking about, and that is where I think we have a real problem unless we have the President helping out by actually telling the American people the problems that these tremendously high deficits are going to give us.

Senator ARMSTRONG. Thank you, Senator Chiles.

Senator Boschwitz?

PAST FORECASTS HAVE NOT BEEN TOO RELIABLE

Senator BOSCHWITZ. Mr. Stockman, I found your analysis of all the forecasts very interesting, when you compared the forecasts of one group to another on deficits, the degree of growth, the recession, inflation, and interest rates for the coming year.

I might say that we have spent a considerable amount of time in this committee contesting the forecasts of various Presidents—at least two since I have been here. I might also say that some of the more spirited moments that I recall in this committee have come particularly between Senator Hatch, who is not here today, and former Chairman Muskie because of these differences in approach, differences in computer models, and differences in projections as to what the future was to bring.

I have become, I must tell you, somewhat jaded about these projections. They have not been very good in the past, and I am not quite sure how the projections are going to be in the future. But on the other hand, I am fairly optimistic because I see a consensus forming. This consensus is not only within the committee, as you have heard both sides of the aisle speak about what they want to achieve—the goals are certainly the same—but I see that same kind of consensus forming in the country.

There are many things within the President's budget that I can support. However, as you know, Mr. Stockman, I have some problems with going after just a few and not all of the programs in the budget, including defense, even though in the past I have voted to increase defense spending because of what I perceive as a diminishing strength in comparison to the strength of some of our potential opponents.

REDUCTIONS SHOULD BE ACROSS THE BOARD

But I have the sense, as you know, that we have to make reductions across the board, somewhat along the lines that Senator Chiles has mentioned, and Senator Hollings and Senator Symms. Reductions have to be broader and all programs are going to have to be attacked, if that is the right word, if we are going to be sustained in any of the reductions.

What we are going to do is bring out the very powerful constituent groups of each of these programs unless there is a sense that there is a reduction across the board of all programs. Reducing across the board makes the arguing somewhat easier for a person in political life, like myself, to defend these reductions to constituent groups.

What do you think, therefore, Mr. Stockman, about a broader approach—an approach which would reduce some of the President's increase in defense would bring all elements in the entitlement area under control, and perhaps not be such a forceful attack on the appropriated programs of Government?

What is your attitude on a broader approach to the cuts as I have suggested and outlined?

LARGE OPTIONS AVAILABLE TO GET ADDITIONAL REDUCTIONS

Mr. STOCKMAN. Well, Senator, I think I would respond this way. If you move into other areas or proposals that are not contained in our budget, we will give them an honest evaluation and a sincere look and judgment as to whether this fits in with all the objectives that we are trying to balance here.

But I would only suggest today that it seems at the moment that there are large options available and relatively painless and easy ways to get these additional reductions that you want. But after you move from the phase of recipe into the phase of detailed scrutiny, you will find that the choices are tougher and that the margins for change might not be as great as they appear right now.

The second point I would make is that the President must propose a budget on the basis of what he believes is right for the country and what is the right policy, not on the basis of what can pass on a common denominator basis, as somebody judges the political mood in the Congress in March or April.

Once his budget is proposed and it becomes a blueprint for policy and the various objectives are weighed and the choices are made, then we get into the disposal part of the process, in which we get your reactions and your compromises.

But at this stage, I am not going to talk about other ways to do it. I am going to talk about what we have proposed and try to convince you that there are a lot of things in our budget that are being summarily overlooked at the moment that must and will be part of any final package that the legislative process produces.

As you seek your own recipes, you are going to have to carefully consider some of the elements that we have proposed as well.

ONE-THIRD OF BUDGET AVAILABLE FOR FURTHER REDUCTIONS

Senator BOSCHWITZ. I will certainly do that. I do not think it is going to be easy, as you have suggested. If you eliminate reductions in defense, which is about 25 percent of the budget, and payments which are 11 percent, and then you place off limits most of the entitlements such as social security, you are left with approximately one-third of the budget to impose reductions upon for the purpose of balancing the entirety of the budget.

Maybe I do look at it too politically, but nevertheless I submit that it just will not work and we have to have a broader approach. I think the President's approach is not broad enough to achieve the ends we all apparently want to achieve and our constituents very much in accord with.

TAX DECREASES ARE IMPORTANT ELEMENT IN RECOVERY PROGRAM

I might say that I did not sense, as some of my colleagues on the other side seem to have, that the populace will so easily waive the tax decreases that we have enacted. I think they are looking forward to the tax cuts. I think they are an important element in our recovery program, and I certainly side with the President in the implementation of each step of that program.

But, Mr. Stockman, I do believe that we are going to have to take a broader brush at all elements of the budget. As you know, I have begun that process, and will continue and try to get support on both sides of the aisle.

I like the Senator from South Carolina's plan. Mine varies a bit from his, but we will attempt to get together on it. I want to repeat that I have a fair degree of optimism of the budget process for this year. I read that some people think the budget process is in jeopardy, and I do not agree.

I hear from some of my colleagues that there is quite a unanimity of views. There is a developing majority viewpoint that the path the President is following is the path we want to follow. I have sense that from the Minnesotans I have visited this year, and also from other people in the business community who have talked with me.

So, as we approach this in a broader brush, I am pleased to hear that you will look at, accept, and review these viewpoints, and perhaps adjust some of the viewpoints of the President for the purpose of achieving the goal that we both want to achieve.

Senator **Armstrong**. Thank you, Senator Boschwitz.

Senator Metzenbaum?

CUT IN NUTRITION PROGRAM WOULD AFFECT ELDERLY

Senator **Metzenbaum**. Mr. Chairman, first, let me thank my colleague from Louisiana, Senator Johnston, who has permitted me to go ahead because I must leave for another commitment.

Mr. Stockman, about 10 days ago, I conducted a hearing of this committee in Dayton, Ohio. For many years, Dayton has been known as the sort of middle-America weather vane of public opinion. The area is almost like magic town for the pollsters—a microcosm of America.

I listened to the people of that community speak, and I say to you that my State is in trouble, the Nation is in trouble, and, above all, you and the policies you espouse are in trouble.

I spent more than 3 hours listening to senior citizens and persons who work with senior citizens. It was a sad, sobering and heartbreaking experience. I would like to take you back with me to Dayton. I would like to have you visit one of the nutrition centers, where that one hot meal a day might be the only food that a 73-year-old woman gets.

I would like you to talk with the director of one of those centers, who told me, actually with tears in his eyes, about having to be a sort of a triage officer who has to make the decision as to who is hungry, who is very hungry, and who is starving, and then withhold the meals from the least hungry. That is actually happening today.

Now, you are proposing to cut the nutrition program by $47 million. Mr. Stockman, I mentioned at that meeting that maybe I ought to bring you there, and the head of the nutrition program agreed, but he added two stipulations. First, you had better bring your own lunch because they do not have the food to feed you. And, second, you had better bring some bodyguards because these people are not just upset; they are elderly people who are downright angry.

They are angry because they do not feel they are asking for charity or handouts. They just want a little help to live out their few remaining years in dignity. They have spent their lives working to make America the great Nation it is, and all they want is to be paid back a little of what they have given to this Nation.

They want this Nation to be strong and to be safe from its foreign enemies, but they cannot understand why billions are being spent to increase our military budget, and programs that are meaningful to those who live here and who have paid their dues are being cutback.

I really do not want to hear any more talk about the safety net because there is no safety net, and you and I and the American people all know there never was one. It was a great catch phrase, but it was not there. And you and your computer and the ivory-tower economists have let the people of America down.

Your budget last year, the so-called new federalism, and the supply side economics—all of them are nothing but words on scraps of paper and they really have no resemblance to the world in which we live and to the reality of America.

BUDGET CUTS WERE CRUEL, INHUMANE, UNFAIR, AND UNJUST

I might say to you that when you came here originally, I said to you that your budget cuts were cruel and inhumane and unfair and unjust, and time has proven that to be exactly the case. They are unjust and they are discriminatory. You zero in on the programs that mean something to people, and you throw a pittance as far as zeroing in on the tax loopholes that exist.

In the Atlantic Monthly article you indicated, as you indicated at this committee, that you had indeed brought those subjects up at the White House, and here you have a proposal that amounts to a few billion dollars. But there are $20 and $30 billion of tax loopholes about which you could do something.

This administration wants to cut energy conservation by 94 percent, and solar energy funds by 72 percent. But somehow they find, because it is good politics, the funds for the Clinch River breeder reactor, to increase that $194 million in 1982 and $252 million in 1983.

You cut back on kids' breakfast programs and child care feeding by 30 percent, and food stamps are going to be cut by 18 percent. But you have got all the money in the world for new subsidies for sugar and sunflowers. Is that not great? Those programs are going to be funded, and the tobacco subsidy will be maintained at $200 million a year.

You cut back on environmental research and enforcement, and national park funds, and historic preservation funds are going to be eliminated, but you have plenty of money for funds for western water projects under the Bureau of Reclamation, which are increased by $47 million for new starts.

I do not have to give you a whole list of the numerous social programs that are being cut back while the defense outlays are being increased by 18 percent in fiscal year 1983.

Mr. Stockman, all I can say to you is that I think the American people want a budget that is balanced. I think they want an America that is fair. I think they want an America that we leave to our children that as equally as good as the America that we found when we came here. Frankly, your programs are not going to do that.

Your programs no longer have the credibility they originally had, and your programs truly are unfair and so discriminatory that I think it is time for a reassessment. We all want to achieve the same goal, but not in the manner that you are proposing.

Thank you, Mr. Chairman.

Senator Armstrong. Mr. Stockman, did you want to respond?

Mr. Stockman. Well, Mr. Chairman, I do not think that was a question.

Senator Metzenbaum. I think it was.

BUDGET CONTAINS $210 BILLION FOR ELDERLY

Mr. **Stockman**. I do want to say one thing, though, because I appreciate what Senator Metzenbaum is saying. I know I am in trouble when it is his turn to ask a question, but I also know why, because he has been consistent in his viewpoint over the last 2 years about what ought to be done and about his basic unwillingness to accept or embrace this program.

So, I understand that, and I appreciate your critique; I just do not agree with it. But I would like to call to your attention one thing that it seems to me people of goodwill could solve.

You mentioned the nutrition center for the elderly and the fact that there was not enough to go around. Now, it is true that there is $210 billion in this budget for the elderly, and it is not all social security. It is medical programs, it is nutrition programs, it is social service programs, and so forth.

I cannot really understand, Senator, how all of us, with our capacity to think and to work things through, cannot find some way to insure that with the spending of $210 billion—$16,000, on average, per elderly couple in this country—that anybody has to end up in the position that you found or you have mentioned here today at the nutrition center in Dayton. There is no way that that should happen.

Now, I know that elderly program, and there are 600,000 per day funded in that, except we do not charge for them. I know that in my old district when I was in Congress, I had centers all over the district and we had all kinds of people going in who had adequate pensions and adequate social security who went in and got the free meal.

Now, if we have got the problem that you have talked about, can we not take that national program, or can we not take money from some of the other areas in this $210 billion segment and make sure that those who do not have any money and who cannot defray and cannot pay, get the hot meal a day that they need?

I do not think that is a difference between this administration and you or between anybody else on this committee. I just think it is astounding that it cannot be done and that we could not revise slightly that program to make those pay who can, to insure the money goes farther for those that cannot.

Senator **Metzenbaum**. Come with me to Ohio and let us try it.

Senator **Armstrong**. Senator Gorton?

DISAGREEMENT WITH PRIORITIES IN BUDGET

Senator **Gorton**. Mr. Stockman, I thank you for coming here and for defending with your usual eloquence and detail the budget proposal which you have submitted. To this point, of course, you have listened more to comments and concerns from members of the committee than you have to questions on the details of your proposals or any others. But I think you have recognized that you have listened to those comments because there is a very great degree of dissatisfaction with the budget which has been submitted.

Part of the dissatisfaction is on the grounds outlined by Senator Metzenbaum, a disagreement with priorities within the budget. An even more widespread source of that disagreement is what was expressed by Senator Hollings—the fact that it simply does not appear to get us from the point at which we find ourselves today to a strong and assured and long-lasting recovery because of the deficits which are built into it.

In answer to a question from Senator Boschwitz, you asked us to concentrate more on what was in that budget itself, indicating that at this point, you were here to defend it, and at some future point you might wish to comment in detail on what Senator Hollings proposed or the slight variant to that which I have proposed and that which has come from Senator Boschwitz.

SENATOR HOLLINGS' PROPOSAL

Nevertheless, in spite of that answer, I would like to ask you to comment, if not on the different value judgments involved in Senator Hollings' proposal or my own—and mine differs from his because I feel much more strongly that we should continue the individual income tax cuts this year or Senator Hollings' proposal, which, of course, you have had for the last 2 weeks. Will it get us from here to there? Do you feel that the assumptions in his proposal and in the other similar proposals are such that if there were the political courage to deal both with the defense budget and the entitlement budget and the revenue directions of his and similar proposals—would they, if adopted, in fact, meet his own stated goals of balancing the budget no later than 1985, and would those sharply reduced budgets, in your view, have a salutary and relatively quick impact on lowering the interest rates and inducing economic recovery?

Mr. STOCKMAN. Senator, I would answer this way, without providing extensive detail and comment, that on an accounting basis, yes, Senator Hollings' proposal would get us there. He uses a relatively restrained forecast. His numbers add up all the way across the board, as far as we can tell. We do not think the COLA savings would be quite as large, but that is only a minor difference.

But the second point that I would make is that it would get us a lot of other places, too, that we might not want to be. And I know that Senator Hollings has been a strong supporter of defense in the past, and he makes a judgment at this time that we need to stretch and delay; go on with the program, but stretch and delay, in light of the financial crisis that we face.

PROPOSED NUMBERS NOT PRACTICAL

But the numbers that he has in his proposal I do not think are practical; I think they are too large. He would propose to take $19 billion, for instance, out of 1983 from the CBO current services base. But, of course, the President's defense budget is much higher than the CBO current services base, and he would have to take $26 billion in outlays, which would be something like $50 or $60 billion in budget authority. And for the entire 3-year period, he would have to take out well in excess of $100 billion from the President's budget, although a lower figure from CBO, to get the outcome he wants.

Now, I think when you get into numbers in that range, you are not in the practical area anymore. You are getting the right numbers, but you are also getting a severe threat to our national security position and jeopardizing what we need to do to rebuild our posture.

So, I will not comment beyond that, except to say that the numbers get us there with the big formulas, freezes, COLA's, and so forth. But then let us analyze very carefully what other consequences, what other costs, and what other impacts we have along the way.

Now, I think that Senator Hollings probably intended this to be a starting point, and just as we have indicated everything is not final in our budget and we are looking for other ideas, I am sure he feels the same way. But I am only saying that somehow this process has to move toward practicality, and in that particular dimension I do not think the proposal is practical at all. So, therefore, the numbers are inflated in that area.

RETREAT FROM TAX CUT

Now, on the tax cut, here the President has said that there cannot be any fundamental retreat; he said fundamental retreat on the essentials of his tax policy. But as I calculate it out, it appears that Senator Hollings would ask us to take back about 40 percent of all the tax reduction in ERTA, the Economic Recovery and Tax Act of last year, over the next 3 years, and about 50 percent of the individual rate reductions.

Now, I am not sure how, when push comes to shove, one would define "fundamental retreat." But I do think that taking back 50 percent of the tax cut, which was the centerpiece of what the President had a mandate to do for the taxpayers and the economy of this country, does get you into the area of fundamental retreat. So, we would have to say that that is not very practical either.

But it would seem to me that once you begin to go through that kind of analysis, we can narrow things down and we can see this process coalesce. I know that everyone is throwing brick bats at our budget. We are not going to start doing the same thing with proposals that are made in good faith on the Hill, except to say that we need to move toward an area where a full variety of objectives can be preserved and balanced.

That is a difficult thing, and it cannot be conducted here with all these TV cameras and reporters in front of this particular committee, but the discussions must and will go on over the next several months.

SOME FUNDAMENTAL CHANGES NECESSARY

Senator GORTON. What you have done, of course, in dealing with the two specific areas in the Senator from South Carolina's budget is to indicate a process which you obviously went through yourself in coming up with your budget. But some fundamental change is, of course, necessary, and I can say only that I share very precisely the goals which were outlined by the Senator from South Carolina. And I think that probably you have come to realize that the great bulk of this committee does as well, and some fundamental changes are going to have to take place. It seems to me very unlikely that we can have any sacred cows as we pursue that process.

Senator ARMSTRONG. Senator Johnston?

BIPARTISAN EFFORT AND COMMUNICATOR NEEDED

Senator JOHNSTON. Thank you, Mr. Chairman.

Mr. Stockman, I believe that the economic Dunkirk is here. I believe that this situation is more serious and that the recession is deeper and wider and more virulent than anything we have had since the Great Depression.

Frankly, I am frightened enough that I am willing to join in and do some things that are very politically unpopular, and I think all of us have got to pull together in that spirit that my colleagues have talked about of bipartisanship.

Now, bipartisanship means also, as Senator Chiles said, that we have got to have the great communicator. Let me talk about some very practical problems about how to get from here to there.

Last year, this committee began with a process that would have saved, as I recall, $36 billion in 1984 and a little less than that in 1983, and that was to cut the rate of increase in entitlements to the lower of the CPI or the wage index. This committee passed this proposal in a bipartisan effort. The proposal went to the floor and it passed on the floor, and then the Republicans on this committee went to the President and there was a long and heated meeting—maybe you were there—in which they tried their very best to sell that proposal to the President, recognizing that entitlements are so big and growing so fast that you can hardly get a handle on this budget without it, and the President said, "No."

Now, you are telling us that the President says that there can be no fundamental retreat. Indeed, the President's budget has, so far as I know, not one single supporter in the Congress—at least not one single supporter that I know about on this committee. If you think you are going to get anybody on this committee to endorse a $92 billion deficit in fiscal year 1983, I think you are dead wrong. That deficit is not close to being approved.

Now, I read in the press—and I therefore know it is correct—just yesterday that the overwhelming majority of his advisers, including you, advised the President that $92 billion was too high as a deficit and that he should retreat—they did not use the phrase "fundamentally retreat"—but that he should retreat from his tax cuts.

Now, in view of our experience of last year where this committee screwed up its political courage and voted for those cuts in entitlements, only to be slapped down, and in view of the fact that most of the President's advisers—maybe all of them—including you, have advised that this budget is fundamentally flawed because it does not deal with taxes, how can we join together in a bipartisan way without risking having Senator Hollings come out and propose some things that are very unpopular, and then have the President say, "Oh, no, we cannot turn our backs and we cannot balance the budget on the backs of the taxpayers," or some other cute phrase?

If we are going to join together, it has got to be with the communicator in the lead, if we are going to do these unpopular things.

Now, tell us how we can be statesmen and try to save this country from what I see as the brink of depression and get it practically and politically done. In effect, how can we have a fundamental retreat and yet let the President save face?

BULK OF PRESIDENT'S BUDGET MAKES SENSE

Mr. STOCKMAN. Senator, I would have a hard time advising you on how to be statesman-like, because I think you are. My purpose here today is to answer questions about the contents of this budget and try to implore you to take a look at it.

If you don't like the bottom line or if you do not like the overall, there are a lot of details and specifics and contents that I think you can agree with, because they embody many of the things you have recommended in the past.

What we have proposed in this budget will be a good part of the solution; I will tell you that today. There may be other things that will come from this committee, from Senator Hollings or from you. But no one is going to have a monopoly on this; it is going to take a lot of elements put together to achieve it.

So, I cannot advise this committee on tactics; I cannot advise this committee on politics. I can explain to this committee what we have proposed and the fact that the great bulk of it makes sense, and that that part of it ought to go into the equation that you finally put together.

Senator JOHNSTON. If I may interrupt, I am not trying to get you to advise this committee on how to begin. What I am telling you is the President has got to lead, in my judgment. Senator Hollings has given an opening, but he cannot go much further with it by himself.

I mean, some of us went over there and praised Senator Hollings, including the majority leader. Of course, everybody was very careful to say, "I am not embracing this, and I reserve the right to disagree with it in whole or in part," recognizing that nobody wants to be blamed for "cutting social security," when it might not fly.

I mean, it is one thing to make a sacrifice; it is another thing to make it in a quixotic cause. What I am saying is, if you want us to make some sacrifices and give some political blood, you had better get your man down there to make a fundamental retreat. We will try to give him a way to do that, but $92 billion is just not going to fly.

BIPARTISAN CONSENSUS NEEDED

Mr. STOCKMAN. Well, Senator, on that score—you have brought it up twice now about the COLA matter and the fact that it was in Senator Hollings' proposal last year and there was a meeting, and so forth; I remember that well.

But I also remember that that was right in the week or two before we had presented our own social security reform plan to the Ways and Means and Finance Committees. And in that plan that came shortly thereafter, we proposed a change in the COLA—a 3-month delay, permanently, to the beginning of the fiscal year—that would have had the impact of $4 or $5 billion a year in terms of budget savings from current law.

It was your colleagues on the other side of the Hill who created such an enormous atmosphere of divisiveness and apprehension and misinformation, both in the Congress and with the public at large, that that proposal did not move.

So, it seems to me, in terms of each other giving advice here on who should do what and who should work on whom, if anything is to happen in that area, I would suggest that it is not a new blueprint we need; it is a bipartisan consensus, and that has to bridge both sides of the Hill, and it will take your best talent and leadership to get that done.

Senator **JOHNSTON**. Thank you, Mr. Chairman.

Senator **ARMSTRONG**. Thank you, Senator Johnston.

I am going to recognize Senator Grassley next, and I would say to the Senator that when he completes his questioning, he may note that I am not here. It is not because I am not eager to hear what his questions are or what the answers are, but because I am scheduled to preside over on the floor.

So, it would be my hope that when he completes his questioning, he would then recognize, in order, others, or pass the baton to someone who can. Senator Grassley?

Senator **GRASSLEY**. I will be over to see if you are presiding.

Senator **ARMSTRONG**. Very well.

[Whereupon, Senator Grassley assumed the chair.]

OPENING STATEMENT OF SENATOR GRASSLEY

Senator **GRASSLEY**. I appreciate your appearance here, in the vein in which you told Senator Boschwitz that you are here to convince us about the President's program and that this is a blueprint for policy that the President thinks is best for the country.

I think that we are here in the same vein, trying to communicate to you in this very official way and in all the unofficial ways that we do our views on this whole policy, so that we can try to work out some useful compromise that at least Republicans in the Senate and Republicans in the White House can follow.

I would say, too, that as I have had an opportunity to visit with my colleagues at least on this side of the aisle about this proposal, I sense that nobody here is bailing out on the President if we object to the total or the specifics of the budget, for the simple reason that I sense that as the President wants to reduce the percent of the gross national product that the budget has grown to become in the last several years, we likewise want to do that.

As the President wants to reduce the rate of increase of the Federal budget, as it has gone up so rapidly in the late years of the 1970's and the early years of this decade—he wants to reduce that and so do we. So, our overall goals have not changed, as I sense the Republicans of this committee working with the White House to come up with some sort of compromise.

PERCEPTION OF UNFAIRNESS ABOUT THE BUDGET

But I think there are certain aspects that the President has to deal with, and so I use this forum to communicate those to you and to the President as well. Amongst the public at large, there is a perception of unfairness about the budget. Maybe I could say that it is not really unfair, but there is that perception out there that must be dealt with. I think we sense that as we go out to visit with our constituents.

It is mostly because of the attitude that defense can get whatever it wants without any question by the President, or maybe even by the Congress, and somehow nondefense things bear the brunt of any budget adjustments, even to the point, which is not true, that the safety net programs, like social security, are being affected, when, obviously, in the President's proposal cost of living for social security is not.

But there is that perception out there and I think it is something that we have to deal with, and I think we are trying to deal with it and we are trying to impress that upon you. I think the very least that it is going to dictate is less defense spending than what the President wants, whether that figure is large or small, but something less than what he has proposed.

DEFENSE IS NOT AN UNQUESTIONED EXPENDITURE

The point of view has to get across to the public at large that defense is not an unquestioned expenditure that just somehow we just appropriate whatever we want on. I would say that if something is done about defense expenditures and if the idea can get across to the country at large that we are not giving the Defense Department whatever they want and that the President is not unquestioning in that approach and that it is a lower growth rate than what the President suggested, I think that will help dramatically.

But I think an important thing that he has to deal with is this public perception. Now, that is with the public at large. Obviously, policies are made here in the Congress, and so the President is going to have to deal with the practical aspects of it.

I think there is almost unanimity that there has got to be less defense spending, and the President, even as late as yesterday on Cable News as he was getting in the car, said "no compromise." I do not know whether that really lends support to this whole effort of compromise that we must do.

I think the President has not wanted to affect entitlements, and particularly the COLA's. You know, if you add defense and those together and you are talking about more than 50 percent of the budget, particularly if you include the interest.

So, you know, there is very little left to compromise when you talk about everything else. As I abhor the President's position that way, I abhor people on the other side of the aisle that say, "Well, you cannot cut here and you cannot cut there," et cetera. You know, there is nothing left to compromise anymore.

PRESIDENT AND CONGRESS NEED TO COMPROMISE

So, at least from my party's leader, I want some sense that there is something there we can deal with, not a very small segment of the budget that makes it impossible to compromise. So, I think that has to deal with COLA's, and I think it has to deal with defense expenditures.

But, additionally, I guess I would put in a plug for something that Senator Symms has already brought up dealing with the constitutional amendment, and it gets down to this point in time. This is not any different than when I visited with Jim Baker about this when he was in Des Moines with the President and I was out there to hear the President speak before the Iowa Legislature.

Mr. Baker asked me what my posture is going to be when we come up with having to increase the national debt. I said, "Well, you know, there has got to be some give-and-take; you are going to give conservative Republicans who never voted to increase the national debt some accommodation."

I would say that we have got to be able to present to our people and our constituency that we have gotten something; that it is not business as usual. I would say the very least we could have from the White House would be support for adopting that constitutional amendment.

Now, I know that that is a long-range answer and it is not going to solve the problems right now, and I know we have to solve the problems right now and I accept your challenge to solve the problems right now. I would say that that could be done by getting some cooperation from the White House on a lower level of defense expenditure and a freeze on entitlements.

I think that those freshmen who were elected in 1980 have some feeling of direction that we sensed from the mandate of the November elections, just like the President does.

So, I do not have a question. I would be willing to listen to any comments you have, but I did have these points of view that I wanted to express to you. Before I call the next Democrat who is up, if you have anything you want to say, I would be glad to listen.

Mr. **Stockman**. Well, Senator, before you call the next Democrat, I wish you would keep talking. [Laughter.]

I do not have anything to elaborate on beyond what I said before. I note what you are saying and your point of view, and we can leave it at that.

Senator **Grassley**. The list here says that Senator Exon is next. Is that right?

PRESIDENT'S REGARD TO ALTERNATE PROPOSALS NOT HELPFUL

Senator **Exon**. That is right. Thank you, Mr. Chairman.

Mr. Stockman, I am the next Democrat up. I would like to get to some specific questions. I will be very brief in my opening remarks.

First and foremost, I think the American people and the people that I represent from Nebraska want some truth in budgeting that they do not think we have had for a long, long time. I do not say that with any disrespect to you, except that I would say that the perception of the people in Nebraska, from my visits with them last week, really indicate that we would be much better off in reducing interest rates if we were to come somewhere near the Hollings proposal, as compared to the President's proposal.

So, I am glad that you are saying that we have got to work toward a better plan than what you have offered thus far. I would simply say that the attitude that the White House has with regard to alternate proposals that have been presented is not very helpful.

The President said in Des Moines when Senator Grassley was with him that opponents of his budget should either put up or shut up. The next day, Senator Hollings put up, and the next day the White House said "shut up." [Laughter.]

FARM STABILIZATION INCOME

There has got to be some give-and-take.

To the specifics of the budget and truth in budgeting, I look at page 5-61 of the Budget of the U.S. Government, fiscal year 1983, under the title, "National Need: Improved Agriculture," and I think most of us would agree with that. You are familiar with the 1981 Farm Act which provides for a 4-year plan for farm stabilization income.

Yet, I notice that while you say we are going to have about $7 billion in farm income stabilization programs for fiscal 1982, explain to me why you have dropped that from $7 billion to $3 billion, a cut of $4 billion. How do you justify that if we are going to carry out the low target loan prices, as provided in the Farm Act of last year?

Mr. STOCKMAN. Senator, the answer to that is that at the time these numbers were locked up, we did not have an updated forecast of farm prices, supplies and expectations for the 1982 crop year. So, we essentially used the forecasts and the assumptions on which the farm bill that was passed by the Senate and the House last year was based.

Under that farm bill, with that set of assumptions and the loan rates and deficiency target payments in it, the number that you would come out to is the one that we have shown in the budget.

Now, since then, most observers, including CBO, have concluded that the stocks will be higher, the prices will be lower, the loan outlays will be greater, and the deficiency payments will be greater, and so forth. So, this number for 1983 is probably low.

Senator EXON. How low?

Mr. STOCKMAN. Well, let me indicate the next point. In light of that, we, as you know, proposed in January, long after this budget was printed, that we establish a 15-percent setaside for wheat and rice and cotton, and a 10-percent setaside for feed grains, and that we increase even further the incentives to participate by substantially raising the reserve loan levels for the 1982 crop year.

Now, we think that if that has a reasonable prospect of success on reducing production, it can help to back up those high prices that we are projecting at the present time, and thereby reduce projected deficiency payments and loan outlays.

But, frankly, I think our number is probably a couple of billion low, but it was based on what we had when the farm bill passed the Senate last fall. And we believe that these acreage control and production reduction efforts will help keep the increase in costs to the CCC to a minimum.

MARKET VALUE OF WHEAT AND CORN

Senator EXON. On the basis, then, of this figure that you now concede is $2 billion too low—and I suspect that those kinds of mistakes, for whatever reason, are throughout the budget, which makes the $92 billion budget next year pale by comparison with reality—on what price for corn and wheat was that reduction of $4 billion based?

As you understand, the amount of money that farmers are going to contribute to the program basically is tied to the market value of wheat and corn. What did you base the price per bushel of wheat and corn at to come up with this figure that you have here?

[Whereupon, Senator Kasten assumed the chair.]

Mr. STOCKMAN. I would have to supply that for the record, but as I remember, when you and others were pushing the farm bill last fall, we were assurred that there would not be any large deficiency payments because the expectation was that the price level would be above the target price.

So, I am certain that these numbers assume no large deficiency payment outlays, and so therefore the assumed market price must be slightly above the target prices for the 1982 and 1983 crop year that you have in the bill.

I will give you all of those details for the record.

Senator EXON. I would like to have that. I would just say that from my rough calculations, I would suspect that corn would be in the neighborhood of $3.50 a bushel, and wheat about $5. And I know of no one that anticipates that we are going to have that kind of a raise in the commodity prices within a year.

[The information requested follows:]

BUDGET ASSUMPTIONS ON SEASON AVERAGE FARM PRICES AND TARGET PRICES FOR SELECTED COMMODITIES (FROM USDA)

Commodity (price per)	1981 crop		1982 crop	
	Season average price	Target price	Season average price	Target price
Budget estimates (based on then-current crop data):				
Corn (bushels)	$2.65	$2.40	$3.20	$2.70
Wheat (bushels)	3.90	3.81	4.45	4.05
Rice (hundredweight)	9.75	10.68	11.00	10.85
Upland cotton (pounds)	.60	.71	.85	.71
Current estimates (based on current crop data and program decisions):				
Corn (bushels)	2.45	2.40	2.50	2.70
Wheat (bushels)	3.70	3.81	3.90	4.05
Rice (hundredweight)	9.75	10.68	10.25	10.85
Upland cotton (pounds)	.58	.71	.68	.71

DEFICIENCY PAYMENTS

[By fiscal year, in millions of dollars]

	1982	1983
Feed grains:		
Budget		
Current estimate	[1]255	[2]528
Wheat:		
Budget	470	
Current estimate	394	325
Rice:		
Budget	85	22
Current estimate	22	98
Upland cotton:		
Budget		
Current estimate	480	330

DEFICIENCY PAYMENTS—Continued

[By fiscal year, in millions of dollars]

	1982	1983
Dairy purchases:		
Budget	1,058	852
Current estimate	1,908	1,804

[1] Sorghum and barley.
[2] Mostly corn.

ADMINISTRATION NOT IN FAVOR OF CHANGING 5-10-10 TAX CUT

Senator EXON. Now, let me go to the next specific question. You have cited here today the overestimates that were made part and parcel of the budget last year, which is the major reason, you said, for the difficulties that we are facing right now.

Let me pose this question to you. Had you known a year ago right now how the economy would fail to respond to the Reagan initiative, would you still at that time have proceeded with the 5-10-10 income tax cut that you pushed then?

Mr. STOCKMAN. Well, Senator, I do not think it does us any good to speculate on last year, or to play the Monday morning quarterback, or try to revise history. As we saw it then, we thought we had a plausible forecast, and CBO thought they had a plausible forecast, and we all turned out to be surprised by economic events.

One of those was the fact that the money supply dried up for a 4- or 5-month period of time this summer in a way that nobody anticipated. That set off a chain of events—higher interest rates, the recession, and so forth.

I do not think that anything that has transpired since then invalidates the basic policy of increasing incentives for economic activity. My testimony today was only to suggest that the magnitude of the problem is now much greater and that our challenge in solving it is far larger than we expected before.

Senator EXON. Mr. Stockman, my time is up. Just let me say that the key problem that we have here is the one that you are evading time and time again. If I understood the testimony that you just gave us, you are not in favor of making a change in that 5-10-10, despite the fact that we are in serious economic difficulties today with high interest rates, largely as a result of the deficits created by that 5-10-10 tax cut. But you do not want to change it.

Mr. STOCKMAN. That is correct.

SUPPLY-SIDE ECONOMICS

Mr. KASTEN. Thank you, Senator.

We are passing the gavel on this end of the table. I have been asked to point out that the record will be open for 1 week after this hearing. There are a number of Senators who have questions to submit for the record. These questions will be sent to you, and we hope that you can get back to us with the answers.[1]

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[1] See p. 554.

Like everyone else, I have been out in my State, and it is interesting to me that deficits do not matter in Wisconsin. The defense and entitlement budgets do not matter particularly in Wisconsin either. In fact, these programs could be cut in half, or doubled if only interest would be at 11, 12, or 13 percent.

In other words, people do not care about what the specific deficit numbers. As a matter of fact, I am not sure if they even know whether it is in millions or billions. But in a State like Wisconsin, with 72 counties, we have lost 25 Chevy dealers in the last year, and 3 since the first of the year. The interest rates are the cause of the problem.

MOVE TAX CUTS FROM JULY TO JANUARY

It seems to me that there has been an awful lot of criticism of our economic policy and the so-called supply-side economics. It is not well-founded and it has not been well thought out. It is said that we have a supply-side tax cut in place. But, in fact, the program that the President and I campaigned on, and that you have worked for, was for a 30-percent tax cut to take place January, January, January.

At this point, we would have had the January 1981 10 percent in place and the January 1982 10 percent in place. In February 1982, we would have a 20-percent cut in the marginal rates. Instead, today, we have got a 5-percent cut in the marginal rates, which has largely been offset by the already scheduled increases in social security taxes.

The average American family has not had a tax cut. They are going to get 10 percent in July, but it is going to be a year from now before we are where we would have been under the President's original plan.

So, even with the personal tax rate reductions enacted into law, revenues as a percent of gross national product will be 20.3 percent this year, compared to 19.1 percent in 1977 and 19.7 percent in 1979.

Now, the major point of supply side economics is that the negative effects of tight money would be offset by the positive effects of the marginal-tax cuts. The revenue figures that show that this kind of offset will not occur. According to what we are seeing, this kind of impetus or effort to propel us out of this recession is not likely to occur.

What we are now concerned about is a mechanism to propel us out of this recession through real growth.

I want to ask what you think of accelerating the second and third years of the tax cuts from July to January. It would be retroactive January of 1982, and effective January of 1983, as originally proposed by the President.

Before I give you a chance to answer that, I want to say that the whole discussion this morning has been on cuts. Well, the fact is we can cut what we want from these different programs. As I said, out in Wisconsin we do not care if we cut them or increase them, frankly, as long as we could do something about interest rates.

KEY TO SUCCESS IS REAL GROWTH

But it seems to me that the key is real growth. You discussed nominal GNP, but the key to our success is real growth. A 1-percent increase in unemployment is an increase of $25 or $27 billion in the deficit. A 1-percent decrease in GNP is a $66 billion increase in the deficit. Now, that is a real difference compared to a couple of billion here or there that we might be able to squeeze out of defense, entitlements or historic preservation.

It seems to me that we ought to reorient our thinking toward what we can do to get the real growth back in this economy. Would not accelerating the tax cut be one step in that direction?

Mr. STOCKMAN. Senator, I would answer this with two points. First, I remind everyone on this committee that even with the high growth that you indicate as essential to the budget, and I agree—better than 5 percent over the next six to seven quarters—we still have a $146 billion current services deficit with adequate defense in 1983 and a $165 billion current services deficit with adequate defense in 1984. So, the high growth is going to help. In fact, the problem is worse without it, but we have already assumed historically high levels of real growth during the recovery period.

IMPACT ON ECONOMY FROM ACCELERATION OF TAX CUT

Now, could that be increased even more with an acceleration of the tax cut? I do not think that you should rule out that possibility at all, but I am not sure I understand how that would come about. Accelerating a change in marginal rates or incentives by 6 months will not affect long-run behavior, as far as I can see. It will change the amount of after-tax money in people's pockets, but if monetary policy remains unchanged, it will not change total demand in the economy and, therefore, the short-run movement of the economy.

So, it might well be worth looking at, but I cannot see that it will have a major impact on the economy in the very short run. The long-run impact we want from lower rates is already there and people can plan and anticipate that already.

[Whereupon, Senator Domenici resumed the chair.]

Mr. STOCKMAN. Now, that is to suggest that there may be some good possibility of looking at that, but I do not believe that it would have a major impact on the real growth rate in the short run. The real growth rate that we have in the budget is already at probably the highest level that you would want to asssume, to be prudent. Even after all that, we have a pretty big deficit left to face.

ECONOMIC TREND IN REAL GROWTH AND EXPANSION

Senator KASTEN. Your economic projections show that you expect an average growth rate for 1982 to 1987 of 4.7 percent. This is lower than the 5.4-percent average for 1961 through 1966, which was the Kennedy tax cut recovery period.

Your forecast of 5.7 percent real growth during the first four quarters is also lower than the postwar recovery average of 6.9 percent. I have asked you this question in another meeting. Why do we end up taking the 22 quarters that you are taking rather than maybe 11?

Mr. STOCKMAN. The answer to that is it is just arbitrary in the sense that the recovery of real GNP growth starts strong in the third quarter of 1982 and extends out through 1987, the end of the 5-year budget period. So, we simply took the 22 quarters, which is that entire period, to indicate what kind of trend in real growth and expansion we expected in the economy.

As I indicated in my testimony this morning, the growth rate of 4.7 percent is well above the 3.3 percent that we have had over all of those periods since World War II, and perhaps even more importantly, is in the top 20 percent of 22-quarter observations that we can see under good conditions and bad, high inflation and low, and so forth.

But the other factor to remember is that there is something new operating here that was not occurring in the early 1960's, and that is we inherited an economy in which financial institutions had been damaged badly, in which an inflationary psychology had been embedded, and in which inflation had increased at steadily rising rates with all kinds of economic ramifications.

We are in the process now, over the next 4 or 5 years, of squeezing that inflation out of the economy at the same time that we are trying to restore productivity, incentives, real growth, and so on. And there are some cynics around who suggest that you cannot do both. You are either going to have no growth and defeat inflation, or you are going to have high growth and a continuation of the kind of ultimately self-destructive inflation that we have had in the past.

What this forecast which we have in the 1983 budget says is that we can do both at once, but we do recognize the interactive effects. We do recognize that there is a lid on the expansion of the economy if the current tight money supply policy is maintained, and that under those circumstances the high growth rate that we are now assuming is probably the most that would be prudent to expect, given all the surprises we have had thus far and all the unknowns that could dwell and lurk throughout the nooks and crannies of the economy and throughout the psychology and behavior in financial markets in this country and around the world.

Senator KASTEN. Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you very much. If I am right, Senator Hart was next.

Senator BIDEN. He left.

Chairman DOMENICI. Senator Riegle?

Senator BIDEN. He is here.

Chairman DOMENICI. Thank you. [Laughter.]

ADMINISTRATION'S BUDGET IS DANGEROUS TO COUNTRY

Senator RIEGLE. Mr. Stockman, this budget is a farce. It is unfair; its economic assumptions are dishonest. Spending is out of control particularly at the Pentagon. I think the budget is aimed in the direction of national bankruptcy.

This budget is dangerous to our country, and that is the virtual unanimous judgment of every serious financial observer in the country. The fact of the matter is that this is the first time in history that a budget has come down here from an administration where not one Senator, not a single Senator in either party, is prepared to support this budget.

All Republicans and all Democrats from all regions and all philosophies are of one mind, that this budget cannot be supported in this form. In fact, even the Republican leader of the Senate, as you know, within the last 24 hours, has proposed a major tax increase that would go right at the guts of what you have sent up here. You have heard it in a variety of forms from members of this committee today on both sides of the aisle.

What you have is total disarray in your budget. It is totally discredited. If you do not face this fact and face it soon, I think you and the administration both are going to become laughingstocks.

DEPRESSION FEAR GROWS

We do have an economic emergency on our hands, and yesterday's Wall Street Journal probably shows it as well as anything else. This is not the Village Voice; it is the Wall Street Journal. On the front page there is a feature article, and the language used in the headline is: "Depression Fear Grows." It is a long, important, and thoughtful piece. It is not the only piece of this kind being written or the only source from which those comments are coming. They are coming from a number of legitimate sources in this country and around the world.

MICHIGAN UNEMPLOYMENT RATE AT 16 PERCENT

In Michigan today, the unemployment rate is 16 percent. We have 677,000 people unemployed in the State and tens of thousands of additional people that are not counted anymore because they have exhausted their unemployment benefits.

It is approaching that level of disaster in many other States. It is a national problem, not just a problem of our State. We happen to be in the worst shape. There is an urgent need for a major midcourse correction in the economic plan. I think it should be bipartisan; I think it should be immediate as we do not think we have any more time to waste.

And I think you, the President and the other economic advisers have to come out of this dream world that has produced the kind of budget that we see here today. I think you have to come down to Earth. I think you have to face up to the miserable realities of what is actually happening in the country. Even your Republican colleagues have talked to you about those realities today.

I think we ought to cancel the Easter recess. I do not think we should take that recess. I do not think the President should nor do I think the Congress should. I think we ought to put other matters aside and deal with this as it is, as an economic emergency.

As you well know, the Democrats have not at any point been directly included in the administration's budgetary formulations. And although it is a year late, I think it is time for the President to have the Democratic members of this Budget Committee in for a serious, closed-door, and frank discussion on how we bring this budget under control.

I do not think there ought to be any TV cameras. We do not need any Irish jokes; we just need a serious, closed-door meeting to talk about where we go from here.

BUSINESSES BEING FORCED INTO BANKRUPTCY

I would like to ask you one specific question, and I emphasize again that unemployment in Michigan is at 16 percent and is rising. We have 677,000 people out of work in just our State. They are becoming increasingly desperate. There are dozens and dozens of well-managed companies that are coming to me every day which are either sliding into bankruptcy or right on the verge of it. A lot of these companies have been in the same family for two or three or four generations. They are well managed, but they cannot survive in the teeth of this recession and the high interest rates.

To those people who are unemployed and who have exhausted their benefits, who number in the tens of thousands in your State and mine, and to those well-managed businesses that are being forced into bankruptcy, what is your advice to them? What are they to do today and tomorrow? What is the answer?

BIPARTISAN PLAN COULD GET DEFICIT DOWN

Mr. STOCKMAN. Well, Senator, I appreciate the vehemence of your expression, but I am not sure that it leads us any closer to a solution to their problem or the general problem of the country.

We believe this recovery will go forward this year; that those companies will have an increase in revenues and business activity, and so forth; and that those people who are unfortunately unemployed right now, as we go through this correction that results from built-up forces after years and years of misguided policy, will again have an opportunity for a job at the earliest possible date.

Senator RIEGLE. But they are losing their homes; they are losing their cars.

Mr. STOCKMAN. Senator, it all depends on one thing, I think, and that is whether or not over the next 2 or 3 months we can put together—as you describe it, a common plan or a bipartisan plan—to get the deficit down for 1983 and remove the prospect that those large borrowing requirements will be out there in the $100 billion-plus range. That is the thing——

Senator RIEGLE. So, there is no answer today?

Mr. STOCKMAN. There is an answer.

Senator RIEGLE. What you are really saying is there is no answer for today.

Mr. STOCKMAN. There is an answer.

Senator RIEGLE. What is it?

Mr. STOCKMAN. I said the answer is this recovery can go forward and their circumstances can be improved if we can demonstrate pretty persuasively and effectively and credibly this spring, doing our business on the budget——

Senator RIEGLE. That is too late; that is what I am telling you. That is too late.

Mr. STOCKMAN. Senator, every time we have this discussion, you tell me that it is too late.

ADMINISTRATION WASTING TIME WITH PHONY BUDGET

Senator **Riegle**. Well, it is too late. How many times do I have to tell you before you get it through your head that it is too late? It is too late, and you are wasting time now. You are in here with a phony budget that not one of a hundred Senators is prepared to endorse.

You ought to take it back and redo it this week. Are you prepared to do that? No. So, you are basically wasting time, and you are wasting the lives of these people who are caught on the point of your policies. I just think it is wrong.

Chairman **Domenici**. Senator, your time is expired. You asked one question, I think, did you not?

Senator **Riegle**. Yes, and I did not get an answer. I guess I will ask it in my 5 minutes next year when the Director comes back.

Chairman **Domenici**. I would suggest to you that it is not going to do us any good to talk about doing away with the Easter recess or having a bipartisan effort unless we have a solution of our own. I do not know that you would do any better if I were to ask you what you are going to do tomorrow about those people who are presently unemployed.

I do not wish to engage in an argument, but——

Senator **Riegle**. I do have some suggestions, Mr. Chairman. I am not sure that that is why we are gathered here today. I would be happy to share them publicly, and I am happy to share them with you. The problem is that we have an unrealistic budget. You know it and I know it, and time is wasting away. And I have not heard anything today about how we take hold of that problem and fix it and do it right away. I would like to do that; I would like to help do it.

Chairman **Domenici**. We are going to try, and we will take your recommendations into consideration; you can be assured of that.

Senator Quayle?

REDUCING DEFICIT FROM $91 BILLION

Senator **Quayle**. Thank you, Mr. Chairman.

Welcome back, Mr. Stockman. As you well know, I have a great deal of respect for you personally and professionally. You have got a darned tough job and you are doing as well as anybody can.

There is no doubt that the process requires the President to submit, and the Congress to react, to a budget. There is obviously no hope that the actual budget as proposed will get through, which is not unusual. The Congress changes it from time to time. It changed it a little bit last year; it is probably going to change it more this year, and not only the deficit, but the actual mix of the budget.

You talked about working in the next 2 or 3 months to get the deficit down—working with the Congress. Are you implying that we can get the deficit down from the projected $91 billion in 1983 and the outyears of 1984 and 1985 as well?

Mr. **Stockman**. Well, Senator, if you can come up with ways to do that, obviously they would be welcome. But I want to suggest that before you can reduce the deficit from $91 billion, you have got to get there first. At a minimum, that requires $56 billion worth of savings and probably more if you accept a less optimistic economic forecast for fiscal year 1983, which many are inclined to do.

Now, it seems to me that we have got to get the $56 billion first, and the $84 billion for 1984 first, and the $99 billion for 1985 first. What I am suggesting is that as I look at the economy today—and who can predict with any confidence or any certainty, given the kind of transition and volatility that we are going through—I think the situation in the money markets is easing. I think the markets have been assured that this aberration that we had in money supply growth in December and January is coming back under control.

Just in the last 2 trading days, you have seen the short rates come down enormously, historically in terms of that short period of time—270 basis points on the T-bill rate just in a couple of trading days. All of that is preparing the groundwork—and I mean short-term. I am not talking about 2 years, I am talking about the next several months. For this recovery to take off as those short-term interest rates come down, we must persuade the financial markets that the Congress and the administration, working together, will not permit huge deficits to build up for 1983 and the recovery period and choke off the recovery. That is what I am talking about today.

Senator QUAYLE. Do you not think it would be advisable, though, to cut the deficit, say, in half in 1983? That would be progress, would it not?

Mr. STOCKMAN. It would be better than the $92 billion deficit projected by the administration for 1983, and that would be better than the $146 billion current services deficit with adequate defense in 1983.

COST-OF-LIVING ADJUSTMENT NO LONGER APPEARS SACROSANCT

Senator QUAYLE. One of the more interesting proposals that has come forth is the one that is put forward by Senator Hollings. Everyone has at least talked about supporting some of his proposals—the freeze on entitlements, and doing away with the cost-of-living adjustment for 1 year. There is further talk about perhaps having COLA increases at the level of CPI minus 3 percent in the outyear.

For the first time, it appears that the cost-of-living adjustment, even on social security, is no longer sacrosanct, and it appears that there may be a bipartisan effort in the Congress to deal with this very key issue that has been off bounds before.

Now, I would imagine that the President of the United States would welcome this at some juncture; in fact, the Congress may be forcing him to do something that he would welcome with open arms.

Now, could you tell me why the President would not be willing to accept that kind of proposal, if there is a realistic chance at this time that we would adopt it? Are there any down sides to that?

Mr. STOCKMAN. Well, Mr. Quayle, I think you are talking more in the realm now of political tactics than you are of whether or not it is desirable and whether or not it will help.

Senator **Quayle**. Well, there are huge numbers there, as you well know.

IMPORTANCE OF BIPARTISAN SUPPORT

Mr. **Stockman**. That is true. I think, as the President has indicated, he would entertain proposals that had bipartisan support in this or other areas. But now, let me underscore the importance of bipartisan support on that issue.

From my point of view, I would like to see the whites of their eyes first because if I remember what happened last year, Senator Hollings proposed some kind of change in the COLA on the Senate side and it was included in his alternative and, I guess, considered on the Senate floor.

A few weeks later, we offered roughly the same thing in the social security package, and the uproar that occurred in the other body from the other party was simply astounding in the degree of its exaggeration, distortion, and the fear that it generated needlessly, inappropriately, and dangerously among the American public.

I do not think we are going to solve anybody's problem by running that risk again. So, therefore, I would suggest that as well intended as Senator Hollings may be or the members of this committee are intended, bipartisan support has to mean something more than four or five members of this Committee.

ENTITLEMENT PROGRAMS ARE MAJOR PROBLEM

Senator **Quayle**. But do you not believe that one of the major problems, not only in 1983, 1984, and 1985, but if we are really going to get our fiscal policies in order, is the entitlement programs, the cost-of-living adjustments, and the CPI that was instituted in the 1970's for political reasons?

Do you not believe that this is really a serious reform now emerging in this committee in a bipartisan effort? This committee has taken the lead. It has been said time and time again that we have got to have the President as a full partner.

Perhaps this is part of the strategy of the administration, to just let the Congress percolate a little bit and come up with bipartisan support. I would hope that you would not try to shove it off and give us political excuses for not accepting it when, for economic and fiscal reasons, it makes a great deal of sense to me. I would believe that you would concur with that.

Mr. **Stockman**. Analytically, you have a sound case. I would also point out, though, that there are more things that need to be done on entitlements than simply the matter of adjusting or modernizing the COLA, and we have got a lot of that. It is a start, but it will not solve your problem.

We have $52 billion worth of entitlement reforms in the budget for the 3 years in the resolution. And just as you have proposed to us that we look at COLA's, I would hope that you would look at these other matters, too.

Senator **Quayle**. We will look at it, but before it has always been off bounds to talk about cost-of-living adjustments, and now it appears that perhaps it is not off bounds to talk about cost of living adjustments, even in social security. That is a fundamental change of attitude here in the Congress, and I would hope that you would encourage that kind of thinking to continue.

Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you.

Senator Biden?

Senator BIDEN. Thank you, Mr. Chairman.

Mr. Stockman, you have had a pretty rough day here. Not a single Democrat or Republican has agreed with you. Let us talk about something you and I can agree on—El Salvador. [Laughter.]

WASTE OF TIME DISCUSSING PRESIDENT'S BUDGET

I sincerely wish you were Secretary of State instead of the Budget Director at this juncture. Based on your past history in foreign policy, we agree completely, and I would urge you very strongly in your idle moments to speak to Haig and Weinberger and the President on El Salvador.

Now, leaving the area we can probably agree on, let me, as they say, set the record straight as best I know it. In arguing about the social security, what happened before, and your submission several weeks later, and the COLA—we had an agreement here, and so on and so forth—one of the things that did change is that when you went over to the House side, you went beyond the COLA. That was what caused the real cry; that is, you went to early retirement, you went to reducing replacement rates. I mean, you went into other things beyond the COLA.

Now, I am not suggesting that my Democratic friends would not have seized upon the opportunity, were they not included. But I think it is important to state for the record that it was not just COLA that you went to the other side of this Hill with; you went beyond that.

I mean this sincerely; I admire you greatly. I think you are the single most articulate spokesperson and the single most credible source the President has to argue for this budget, because we either know through the press or through people who—this is a small town—some of the scars that you have incurred as a consequence of making some of the same arguments that we are making here, and I assume the chairman made, and not successfully, with this administration.

So you come, at least from my standpoint, with a great deal of credibility as you speak before this committee. But I am getting a little bit confused, not by you specifically, but by the program.

In the past, whenever the President has submitted his budget, it has been the function of the Budget Director to come up here and talk about that budget. But there has always been an implicit assumption that somebody besides the President supported that budget. I am not being facetious now; I really am not.

And we usually abandoned talking about the President's budget when it became clear that there was no possibility of consensus for that; it made no sense to continue to discuss it. Carter sent up a budget not long ago. Thank God, he is your President and not mine now, Reagan, and I do not have to defend Carter, but we Democrats got together and said, "Hey, Mr. President, that will not fly;

take it back. We do not even want to see it; do not even try to justify it to us; it is just not going to get anywhere."

Now, I think you probably figured out today what you probably already knew before you came, because you are a pretty smart fellow, that it does not make any sense to discuss your budget. We are wasting time discussing your budget. Aspects of the budget we can discuss, but the budget as a whole is not even a bargaining chip; it is not even a place from which to start. There just is not anything to it that will get any consensus.

And, again, it puts you in a tough spot. You are here to defend the budget, and you were right when you said we would talk about it. But the only thing that makes this a different circumstance is that we have reached a point that usually takes 2 months or 6 months; we have reached it in the first day, and that is nobody likes it. Nobody wants it; nobody is going to entertain it.

PRACTICAL RANGES MUST BE CONSIDERED

The second point I would like to make is that you used the phrase five times that I noted today—you said we must talk about practical ranges. The phrase was "practical range"; you used it with regard to assumptions, you used it with regard to deficits, you used it with regard to several other items. I think that is a good phrase to use, "practical range."

My question to you is do you believe that a $92-billion deficit in 1983, an $83 billion deficit in 1984, and a $72 billion deficit in 1985 are within practical ranges?

Mr. **Stockman**. Practical ranges in terms of the ability of the economy to tolerate, or the ability to get there?

Senator **Biden**. Both.

Mr. **Stockman**. Senator, I wish I could tell you there was some easy way to get them below that, but I know that as time goes on, there are going to be reestimates the other way; there are going to be differences of opinion in Congress as you get down to the nitty-gritty details, not the roundhouse formula.

I think we would all consider ourselves fortunate and that the economy would be much better off if we could get to those deficits that we have proposed by the time the whole process was finished.

Senator **Biden**. I agree with you. If the budget stays as it is, I think those deficit numbers are optimistic.

Mr. **Stockman**. Yes.

Senator **Biden**. I come from a little State, the State of Delaware. And we are all very parochial around here talking about our States. I am glad to hear that in Wisconsin, they can cut entitlements. I am going to remind the guy who runs against him of that; you know, just cut them in half, no problem. [Laughter.]

In my State, I want to say for the record, they are concerned about entitlements.

But all kidding aside, my State has a mildly corporate orientation, the State of Delaware. [Laughter.]

BUSINESS COMMUNITY WANTS CERTAINTY

And do you know what is happening in my State? I mean this sincerely. The thing that I have always heard, and I think it is correct—the Republicans have been saying to me since I have been on this committee that the business community wants certainty; they want to be able to plan ahead a little bit. The President's whole program was designed to establish some certainty.

And I mean this sincerely when I say it: the biggest impediment, I think, to any recovery, even beyond interest rates, is business uncertainty out there. And do you know what they are telling me they are uncertain about? Now, these are not the little guys; these are not the Chevy dealers. Those folks have already left; they do not want to hear anything about it.

These are the big guys, the big hitters. The big hitters are telling me, "Hey, Biden, we know that you guys are not going to be able to live with those $92 billion deficits and they are going to be more like $150 billion. We know you cannot live with a deficit that way; we know that. And we know you are going to cut it, and it scares the living daylights out of us where you are going to cut it. So, we are not going to go out and invest in a project that is going to take us 5, 10, 12 years down the road, because you may take away our tax cut. You may take away the particular portion of the budget that helps us in our business. We know you are going to do something."

So, here we are. They know out there we are going to do something, we know we are going to do something, you know we are going to do something, and all those business folks out there are doing nothing because they are scared to death.

Now, I do not know how you are going to be able to do something about that number. I think you guys are right, by the way; I think Secretary Regan was right when he said deficits were figuratively overblown in terms of their significance. He is right. We Democrats have been making that argument for a long time, except that you have made such a credible case that they are not overblown that he is incredible in terms of when he says it.

BUSINESS COMMUNITY FOCUSING ON DEFICITS

So, now they are there; the business community is going to respond to them. The Senator from Wisconsin is correct. My constituents are not focusing on deficits, but the business community is, and I do not know how they are going to move unless something is done about those deficits.

I am convinced that they would begin to move and spend the capital that they now have. Those big guys are not short on dollars now. It is not the case, as my distinguished friend from Iowa said, that they are illiquid. They are liquid; they just do not want to spill any of it. [Laughter.]

You know that as well as I do. That is what they are doing, Dave; they are afraid to go out there. So, what are we going to do to get that number down? If we start off with the premise that they are not going to accept even $92 billion, and you and I know it is above $100 billion, what are we going to do to get them to start to spend the money they have and to invest what they have now?

They will do it even with the interest rates the way they are now, in my opinion, if they think we are not going to come and take it away from them. Is it not better to tell them now what we are going to take away, how we are going to take it away, and get on with it?

Mr. **Stockman**. Well, Senator, I appreciate some of the comments you are making. I think there are some kernels of insight amongst all of it for the committee to look at.

Senator **Biden**. With all due respect to the chairman, this committee does not matter.

CANNOT AFFORD REPEAT OF CONGRESS REWRITING BUDGET

Mr. **Stockman**. Mr. Biden, let me suggest one thing. I appreciated your history and your suggestions on what it will take prospectively to get the job done. And I do remember what happened when the Carter administration sent a budget up here; I was a Member of Congress. We all said it was terrible; "send it back, go away."

Off the budget, there was $16 billion in deficit in March of 1980, and so then Congress took things in its hands and rewrote the budget. And lo and behold, it turned out to be $60 billion in deficits when the year had finally ended.

So, what I am saying is we cannot afford a repeat of that experience, and that neither budget in that particular instance of historical record did the job. I hope both sides can learn from it this time and that we will put something in place this spring that will have far more satisfactory results for all parties concerned than the previous episode in this same kind of apparent stalemate that is developing here in these initial weeks.

Senator **Biden**. Mr. Chairman, in light of the fact that I have been patient and am the last one, can I have an extra minute?

Chairman **Domenici**. Sure.

Senator **Biden**. Thank you, Mr. Chairman.

Chairman **Domenici**. You be nice.

Senator **Biden**. I will be real good. I was not kidding about it; I really do agree with you both on foreign policy and that you are brilliant. That is about it. [Laughter.]

CHANGE TAX CUT

You know, we go back to the question about fundamental retreat and all the rest of that, and Dunkirks, and all the words we are using. I cannot figure out, no matter how you cut it—if anyone is willing to accept my premise that as long as deficits are around $100 billion, and we are announcing ahead of time that they are going to be in that range—I do not know how, through fraud, waste, and abuse, through food stamps, through cutting every single, solitary program that is out there that the people like—I do not know how we get to making any impact in the front end, even being able to guess at a deficit being substantially lower than $100 billion, unless there is a change in Roth-Kemp.

Chairman **Domenici**. That is Kemp-Roth, is it not?

Senator **Biden**. In Delaware, it is Roth-Kemp.

Chairman **Domenici**. That is right; I forgot. [Laughter.]

Senator **Biden**. I mean, even if you agreed with me, you would be in a spot and you could not say anything. I know you do not agree with me, but even if you did, you could not say anything, but just send the message back. I predict to you that he is going to have to do it.

There is going to have to be a Baker surcharge. They are going to have to change the income tax cut some way, by some trigger device or straight-up change. You are right about defense; you know, you cannot grab $40 billion out of defense this year, in light of the fact that all of my friends on my side of the aisle like to talk about it. It is not going to happen. You have got to do something about taxes, and you have done something; good move. I am proud of you; you are moving in the right direction, but you have got to get at the big thing that is not negotiable that is going to have to become negotiable.

Do not let him have this, you know, Carter's water projects. We cannot afford three Presidents in a row to be abject failures. We cannot afford three Presidents in a row to lose all the confidence of the American people. We cannot afford that to happen. This President has to succeed in order for us to have any prospect of making it through the 1980's and all those other things that go far beyond the budget.

Do not let him be Lyndon Johnson who says, "I am not going to lose a war." Do not let him do that.

Thank you.

Chairman DOMENICI. I am sure that he appreciates that.

Senator BIDEN. Well, I mean it seriously. I mean, I am not joking about how good I think you are.

Chairman DOMENICI. Is it my turn?

Senator BIDEN. Yes.

Chairman DOMENICI. Have you had a turn?

Senator EXON. I have had one turn. I have been waiting patiently for my second turn.

Chairman DOMENICI. You may go ahead, Senator.

CUT DEFENSE PROCUREMENT PROGRAMS

Senator EXON. One quick question on defense budget cuts.

Mr. Stockman, I suspect that you may agree with the thrust of what I am about to say; whether or not you can agree with me publicly is another thing.

I am on the Armed Services Committee and I have been known as a hawk and feel very strongly about our defense, but I sincerely believe that there is no way that we can build a strong defense on a weak economy. Therefore, regardless of what the President says and regardless of what connotation you put on that, the defense budget is going to have to be cut.

Now, some have suggested that we might be able to cut $10 billion or so in outlays by nickel-and-dime types of approaches of improving procurement and all those things. You and I, who understand it, know that that is not going to happen.

Some of us on the Budget Committee and some of us who are on the Armed Services Committee are trying to put together some kind of a package, but if we are going to make some cuts in 1983, especially in the way they affect the outyears, we are not going to nickel-and-dime it. We are going to have to go into some of those procurement programs.

What would you think about canceling outright the B-1? What would you think about delaying the procurement on the MX missile until the administration eventually makes up its mind as to what kind of survivable basing mode we could place that in, just to mention two?

Mr. STOCKMAN. Well, Senator, if you are concerned about defense—and I know you are a strong supporter of defense—and believe that we have got to have a solid economy first, and that we need to do some things in the short run to get the deficit down and get the economy recovered, I think those are the wrong areas to go.

You will not get any outlays, and even if you assume the economy recovers and you have a strong economic base, then in the mid-1980's you have got a fundamental problem of a strategic deterrent that is not credible.

So, I do not think, if that is your view on it, that going after one of these large procurement programs either helps you cash outlaywise or deficitwise in the short run, and leaves you the same old problem in the middle of the decade with even greater urgency than we had in 1981.

Senator EXON. Mr. Stockman, what you are saying, then, is that we cannot cut that 18-percent increase, an increase of $33 billion that the President is recommending. That is what you are telling me.

Mr. STOCKMAN. Well, you mentioned two items out of that increase.

Senator EXON. Well, give me some that we can, then.

NO FREE MONEY IN DEFENSE BUDGET

Mr. STOCKMAN. Well, I believe that we have prudently put together a budget that requires most of those dollars that are in there—the readiness for pay for these new systems. You, as a member of the Armed Services Committee, have far more expertise than I, and you will have the Secretary of Defense here next week. Perhaps you will come up with something.

But I cannot suggest today any ability or way to get large savings out of the defense budget without some cost in terms of security objectives or readiness objectives or strategic objectives that you would have to weigh pretty carefully. People will come to different judgments; I appreciate that.

But there is going to be a cost. There is no free money in there. There is no account called "Waste, Fraud, Abuse and Excess Spending" that you are just going to reach into and reduce. You are going to pay a cost on some objective, and as long as the Congress understands that, then I believe that we can come to a solution down the road a ways that is workable.

Senator EXON. But so that there is no misunderstanding for the record, you cannot give me any area where you think it would be prudent to make any significant or substantial cuts in the defense budget, as recommended?

Mr. STOCKMAN. I would not provide that to you here or anywhere else. I think once, in the administration process, we make a budget, then we must defend that budget—not only the Budget Director, but every Cabinet Secretary and everyone in a responsible position in the administration. And whatever differences we had along the way have to be set aside to defend the integrity of the whole.

If we did not, the process simply would not work, and I know you can appreciate that as well as anybody else.

Senator EXON. One closing statement, Mr. Chairman. All that you are telling us, Mr. Stockman, is that if we cannot cut the defense budget, then we cannot do anything about the monstrous deficit this year and in the outyears that you have presented. And if we follow that course, we are following it, in my opinion, to a deadend as far as the economy is concerned and the defense posture.

Thank you, Mr. Chairman.

Senator RIEGLE. Could I make a unanimous consent request, Mr. Chairman? I have two studies that have been done, one by the senate fiscal agency of the State of Michigan entitled "Analysis of President Reagan's fiscal year 1982-83 Budget and Its Impact on Michigan," and also a second analysis that has been done on a comparative basis of the budget and its impact on various States and upon Michigan by the University of Michigan.

I would like to ask that both of these be inserted.

Chairman DOMENICI. Without objection, they will be inserted in the record.[1]

BUSINESS COMMUNITY WANTS PROGRAM TO WORK

Mr. Stockman, I do not agree with Senator Biden's conclusion. I agree with what is occurring out there, but not with why it is occurring. I have come to the conclusion that we are not going to get economic recovery in spite of the optimism that is out there.

The business community wants this program to work. I do not think it wants to sabotage it. I do not think it can grow unless interest rates come down; in particular, long-term interest rates. I believe they were the phenomena that permitted the American industrial machine to work.

Now, I do not think businesses will be able to invest and to grow until the rates come down. Now, basically, would you tell me whether or not you agree with that?

Mr. STOCKMAN. Mr. Chairman, I agree.

NOT MUCH ROOM LEFT FOR CUTS

Chairman DOMENICI. Now, Mr. Stockman, if that is the case, and if the President of the United States has indicated in this budget that we cannot cut defense, that we cannot touch even the COLA's in social security, and that we can raise revenue, through closing some loopholes and other things, $7 billion in 1983, $13 billion in 1984, and $13.5 billion in 1985, I ask you how we can reduce the deficits significantly beyond what you have proposed?

Might I put it another way? The President has said, "If you can cut more, I will support it." I want to ask you honestly, Mr. Stockman, if military is excluded and social security is excluded, is there really any room in the budget to cut any significant, large amounts that will really affect that deficit?

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[1] See p. 647.

Mr. STOCKMAN. Well, Mr. Chairman, I think there is a great deal of room to do that in terms of the policy merits and in terms of what is practical and possible in this legislative and political climate. I think it would be very difficult to get much more.

But if you examine the budget and what is left, there is a lot there to cut if it could be achieved, but you are talking in the realm of practicality, and I would concede that in the realm of practicality there is not a lot more.

DEFICIT EXPECTATION KEEPS INTEREST RATES HIGH

Chairman DOMENICI. Now, Mr. Stockman, why are interest rates not coming down? I do not want a large, long dissertation. Perhaps, I would ask it in this way: inflation is down more than anyone expected; I think it is in the range of 4.8 percent for the last 4 or 5 months. If inflation is the relevant factor, the rates ought to be coming down. I believe they are not coming down because the expectation of deficits piled on top of our trillion dollar debt leads the investing community at large to conclude that high interest rates exist because there is a crowding-out effect due to the large Federal demand.

Now, if that is not the case and deficit expectation is not the psychology at work, what is at work? If you agree with it, I would appreciate your indicating so.

Mr. STOCKMAN. Mr. Chairman, I agree in the main. Basically, I believe the markets believe that inflation is down, but it is not gone; they are afraid it is coming back. The reason they are afraid it is coming back is they fear that the political system—Congress and the administration—will be unable to treat or cope with those large prospective outyear deficits, and that sooner or later the Fed will be forced into the position of doing what we have done time and time again in the past, to the great cost of this country, and that is printing the money to pay for those deficits and starting another process of rising inflation.

So, it seems to me that what we have to demonstrate is that inflation is not only down, but it is going away because there is a policy in place that will permit the Fed to maintain the anti-inflation policy that we have today. That is the credibility, that is the confidence, that is the expectations issue.

Chairman DOMENICI. Mr. Stockman, I know you have to go, but I want to ask you this question before you go. If the expectation of large deficits is serious, is it serious enough for us to consider it the most important aspect of budgetmaking for the next 2 or 3 years?

Mr. STOCKMAN. I think so.

KEEP EXPENDITURES UNDER CONTROL

Chairman DOMENICI. If we take the domestic programs of this country and reduce them further in a permanent way so that they are on a reduction path similar to the one you have submitted in this budget, would not that activity convince the skeptics that we are not going to let the budget get out of control of the expenditure side?

Mr. Stockman. I think so.

Chairman Domenici. So, what would be left; the deficit right?

Mr. Stockman. Yes.

Chairman Domenici. If we accomplished that, the other thing left for us to address would be the deficit. Is that right?

Mr. Stockman. Well, Mr. Chairman, I think that is right. I do not believe, though, that the markets will look at this or that sector of the budget. I think that they will look at the bottom-line borrowing requirements prospectively and that there are a lot of ways of getting there; that those are now being discussed.

But more importantly than that, not the dollar numbers and not the mix, they are going to look at whether the system can deliver, whether a majority can coalesce, whether a decision can get made, whether laws can be changed to ensure that the Treasury does not have to go out there and borrow indefinitely sums of money like we are looking at now in the face of no action.

BIPARTISAN COALITION IS NECESSARY

Chairman Domenici. Well, Mr. Stockman, I want to tell you in a nutshell what my single condition for a bipartisan coalition is. I hope you will agree with it. A bipartisan coalition is necessary. It will not do the job if those who want to join in putting it together assume that we do not have to reduce the budgetary outlays of this country for 1983, 1984, and 1985. That is, I think, both the beginning line and the bottom line.

From this Senator's standpoint, we can deal with everything else. We can cut defense, and we can look at the tax revenue side. It seems to me that it would be preposterous to get right back where we were, doing those things—reducing military substantially when we know we need a strong military; changing the tax code substantially even on an interim basis to raise revenue—if we are going to be back in the muddle of higher percentages of our gross national product being spent by the Federal Government.

Now, would you care to address just that issue from the standpoint of your entire efforts since you started changing the direction of the Federal Government's budget?

Mr. Stockman. Well, Mr. Chairman, I think that is the bottom line. There is no way to balance the budget permanently by depriving defense; we learned that in the 1970's. There is no way to balance the budget permanently by allowing the tax burden to creep up to higher and higher levels; we tried that.

So, it seems to me that what we have to try and contend with is 20 years or more of built-in spending commitments, entitlements expectations, promises, and so forth. We made a major start last year in beginning to prune that down and reduce it to something that is compatible with our long-term capacity to finance, and that we dare not let up on that quest in this budget or next year's budget just because the political pressures from certain corridors are beginning to rise.

There may be other things to do, but that is the first thing and the essential aspect of any plan to bring about long-term fiscal stability.

Chairman DOMENICI. Mr. Stockman, I would conclude by saying that even if we did that, we would not address the revenue side and the deficits would be so large that I believe we would be in a catch 22. I do not believe you can get that kind of recovery because I do not believe you can get the interest rates down.

So, I am going to try to put together a bipartisan budget. I hope no one assumes that it is going to be done by taking $100 billion out of defense, which is impossible and almost preposterous, and address the revenue side. If people think we are not going to have to bite any hard bullets in between everything from defense to revenues, which are all the domestic programs and all the entitlements, then I assume we will not have any basis upon which to build the coalition.

I thank you. I am sorry we kept you so long.

[Whereupon, at 12:57 p.m., the committee was adjourned.]

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

PRESENTATION OF THE HONORABLE DAVID A. STOCKMAN
DIRECTOR OF THE OFFICE OF MANAGEMENT AND BUDGET
BEFORE THE
SENATE BUDGET COMMITTEE

FEBRUARY 23, 1982

1. OVERVIEW OF CURRENT FISCAL CONDITIONS AND ISSUES

- IN THE ABSENCE OF A COMPREHENSIVE BUDGET SAVINGS EFFORT, THE NATION FACES CONTINUOUS DEFICITS OF UNPRECEDENTED SIZE. ON A CURRENT SERVICES BASIS (NO POLICY ACTION) THE PROJECTED DEFICITS RANGE AS FOLLOWS, DEPENDING UPON WHETHER OPTIMISTIC, MODERATE OR PESSIMISTIC ECONOMIC ASSUMPTIONS ARE USED: (BILLIONS)

FY 83	FY 84	FY 85
$129 - 162	$133 - 197	$120 - 216

- THE PRESIDENT'S COMPREHENSIVE BUDGET SAVINGS PLAN IS DESIGNED TO REDUCE DRAMATICALLY THESE PROSPECTIVE DEFICITS AND ENSURE THAT THEY DECLINE STEADILY FROM THE FY 82 RECESSION PEAK.

	83	84	85
ADMINISTRATION BUDGET SAVINGS PLAN...............	-56	-84	-99
REMAINING DEFICIT...........	92	83	72

o THE REMAINING DEFICITS ARE DUE TO CHANGES IN THE ECONOMIC OUTLOOK SINCE LAST FEBRUARY, INCLUDING RECESSION, HIGHER INTEREST RATES AND A MORE RAPID THAN ANTICIPATED SLOW-DOWN OF INFLATION. ALL OF THESE FORCES OF ECONOMIC TRANSITION HAVE DRIVEN THE BUDGET TOWARD GREATER IMBALANCE -- AND WERE UNIFORMLY UNDERESTIMATED BY ALL BUDGET AND ECONOMIC FORECASTS OF ONE YEAR AGO. BUDGET PROJECTIONS BASED ON ECONOMIC FORECASTS ISSUED LAST YEAR BY THE REAGAN ADMINISTRATION, CBO, DRI AND THE CARTER - JANUARY BUDGET WOULD UNDERESTIMATE CURRENT DEFICITS BY THE FOLLOWING RANGES: (BILLIONS)

1982	1983	1984
31 - 57	40 - 89	29 - 91

- THE CURRENT SERVICES DEFICIT REQUIRING URGENT ACTION THIS YEAR IS OF ROUGHLY THE SAME MAGNITUDE WHETHER CALCULATED FROM THE ACTUAL ADMINISTRATION TAX AND BUDGET PROGRAM ENACTED BY CONGRESS LAST YEAR, OR FROM THE ALTERNATIVE FISCAL PROGRAM EMBODIED IN THE WAYS AND MEANS TAX BILL AND THE HBC FIRST BUDGET RESOLUTION. OUR PRESENT FISCAL PREDICAMENT IS A COMMON CONSEQUENCE OF CURRENT AND FUTURE ECONOMIC FORCES IMPACTING THE BUDGET -- NOT FISCAL POLICY OPTIONS CHOSEN OR REJECTED LAST YEAR.

	83	84
CURRENT SERVICES DEFICIT WITH ADMINSTRATION PROGRAM AS ENACTED..........................	-146	-165
CURRENT SERVICES DEFICIT WITH 1981 CONGRESSIONAL ALTERNATIVES*..................	-150	-149

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* ALTERNATIVE TAX POLICY BASED ON H.R. 4242 AS REPORTED FROM THE WAYS AND MEANS COMMITTEE ON JULY 24, 1981, AND ALTERNATIVE SPENDING POLICY BASED ON H. CON RES. 115 REPORTED FROM BUDGET COMMITTEE ON APRIL 16, 1981.

II. CURRENT SERVICES DEFICIT ESTIMATE: DIMENSIONS OF THE FISCAL PROBLEM

- THE APPROPRIATE STARTING POINT IS THE RANGE OF BUDGETARY PROJECTIONS AT CURRENT SERVICES. THIS REPRESENTS WHAT WOULD HAPPEN IF WE SIT ON OUR HANDS, PERMIT THE BUDGET PROCESS TO POLARIZE OR PARALYZE, AND ALLOW THE BUDGET MOMENTUM TO RUN FORWARD ON AUTOMATIC PILOT.
- THE PROJECTIONS INDICATE SERIOUS DANGER TO THE ECONOMIC RECOVERY, STABILITY OF FINANCIAL MARKETS AND INTEREST RATES, AND THE ECONOMIC WELL BEING OF EVERY AMERICAN.
- THE FOLLOWING TABLE SHOWS A RANGE OF CURRENT SERVICES DEFICIT PATHS BASED ON THE ADMINISTRATION ECONOMIC FORECAST AND TWO ALTERNATIVE FORECASTS:
  - THE ADMINISTRATION FORECAST ASSUMES A RECOVERY BEGINNING IN THE SECOND HALF OF 1982, AN AVERAGE REAL GROWTH RATE OF 4.9% OVER 1983-85, WITH INFLATION FALLING TO 4.6%, UNEMPLOYMENT TO 6.4% AND THE T-BILL TO 8.5% BY 1985.
  - THE HIGHER GROWTH SCENARIO ASSUMES AN AVERAGE REAL GROWTH RATE OF 6.1% OVER THE 1983-85 RECOVERY PERIOD, WITH INFLATION FALLING TO 3.4%, UNEMPLOYMENT TO 4.5% AND THE T-BILL RATE TO 7.3% BY 1985.

  - THE LOWER GROWTH SCENARIO ASSUMES AN AVERAGE REAL GROWTH RATE OF 3.7% OVER THE RECOVERY PERIOD 1983-85, WITH INFLATION FALLING TO 5.8%, UNEMPLOYMENT TO 8.3% AND THE T-BILL RATE TO 9.7% BY 1985.

- THE DEFICIT THREAT TO FISCAL BALANCE AND ECONOMIC RECOVERY TRANSCENDS THE PLAUSIBLE RANGE OF ECONOMIC ASSUMPTIONS, AND CANNOT BE MITIGATED WITHOUT COMPREHENSIVE POLICY ACTION. SPECIFICALLY,

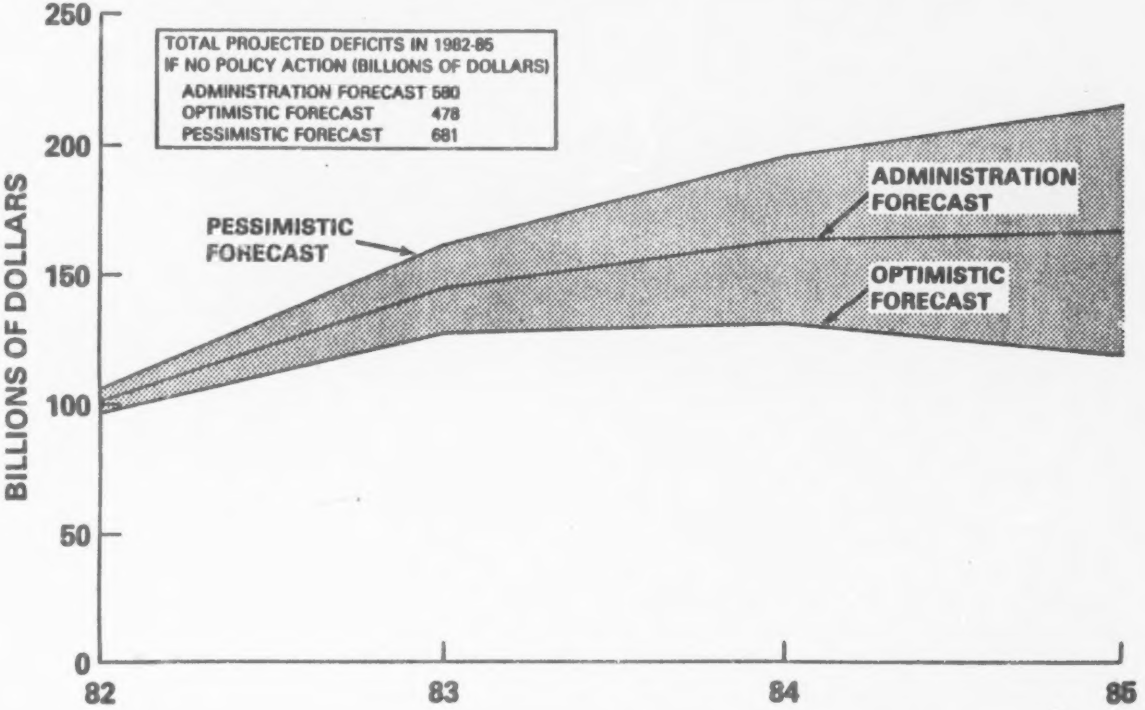
  - THE CURRENT SERVICES DEFICIT EXCEEDS $120 BILLION IN ALL CASES FOR THE FY 83-85 RECOVERY PERIOD;

  - THE SIZE OF THE DEFICIT STEADILY RISES FROM THE FY 82 RECESSION LEVEL;

  - THE CUMULATIVE ADDITION TO THE NATIONAL DEBT RANGES BETWEEN $478 AND $681 BILLION OVER FOUR YEARS.

CURRENT SERVICES DEFICIT PROJECTIONS

(FISCAL YEARS)



III. THE IMPACT OF ECONOMIC TRANSITION: RAPID DETERIORATION OF THE BUDGET OUTLOOK

- THE ECONOMIC OUTLOOK AS VIEWED BY PRACTICALLY ALL ANALYSTS EARLY LAST YEAR DID NOT ANTICIPATE MAJOR DEVELOPMENTS WHICH HAVE DRAMATICALLY ALTERED THE BUDGET PROJECTIONS FOR FY 82 - 85. THESE UNANTICIPATED DEVELOPMENTS INCLUDE:
  - THE PRESENT RECESSION;
  - THE RAPIDLY FALLING RATE OF INFLATION;
  - THE GREATER THAN EXPECTED TIGHTENING OF MONETARY POLICY IN MID-1981 AND THE PROSPECTS FOR SHARPLY REDUCED NOMINAL GNP LEVELS DURING THE RECOVERY PERIOD;
  - THE EMERGENCE OF UNPRECEDENTED PREMIUMS ABOVE THE INFLATION TREND IN NEARLY ALL INTEREST RATES, AND THE PROSPECT THAT THESE PREMIUMS WILL DIMINISH ONLY SLOWLY OVER TIME AS POLICY CREDIBILITY IS RE-ESTABLISHED.

- ALL OF THESE FACTORS REPRESENT ECONOMIC ADJUSTMENT FORCES OPERATING AS THE ECONOMY MOVES FROM A CONDITION OF EXCESSIVE MONEY AND CREDIT GROWTH, UNCONTROLLED FEDERAL SPENDING, RISING INFLATION AND STAGNATING REAL GROWTH TO LOW INFLATION, REVIVED REAL GROWTH AND MONETARY, FINANCIAL AND INTEREST RATE EQUILIBRIUM. ALL ECONOMIC FORECASTS USED LAST YEAR FOR BUDGET PROJECTIONS UNDERESTIMATED THE SEVERITY OF THESE ECONOMIC ADJUSTMENTS AND THEIR ADVERSE CONSEQUENCES FOR THE BUDGETARY OUTLOOOK.

- THE FOLLOWING TABLE COMPARES THE CURRENT ADMINISTRATION DEFICIT PROJECTION -- INCLUDING ALL PROPOSED BUDGET SAVINGS MEASURES -- WITH RE-ESTIMATES OF THE CURRENT BUDGET BASED ON EARLY 1981 ECONOMIC ASSUMPTIONS FROM A VARIETY OF SOURCES. IN EVERY CASE THE DEFICIT PROJECTIONS ARE DRAMATICALLY LOWER BECAUSE THE ECONOMIC ADJUSTMENT FORCES DESCRIBED ABOVE WERE NOT ANTICIPATED. ON AN AVERAGE BASIS, THE CHANGED ECONOMIC OUTLOOK HAS INCREASED THE PROJECTED DEFICIT BY:

  --- $42 BILLION IN FY 82

  --- $59 BILLION IN FY 83

  --- EQUAL OR LARGER AMOUNTS IN THE OUT-YEARS

CURRENT ADMINISTRATION BUDGET RE-ESTIMATED WITH EARLY 1981 ECONOMIC FORECASTS

	82	83	84	85
1) CURRENT ADMINISTRATION DEFICIT ESTIMATE	-99	-92	-83	-72
2) CURRENT ADMINISTRATION BUDGET RE-ESTIMATED WITH EARLY 1981 ECONOMIC ASSUMPTIONS:				
CARTER - JANUARY	-54	-32	-24	-11
ADMINISTRATION - FEBRUARY	-42	-2	+8	+21
DRI - FEBRUARY	-63	-46	-47	-23
CBO - MARCH	-68	-52	-54	-51
AVERAGE DEFICIT, EARLY 1981 FORECASTS	-57	-33	-29	-16

A) THE TIMING AND SEVERITY OF THE RECESSION WAS NOT ANTICIPATED

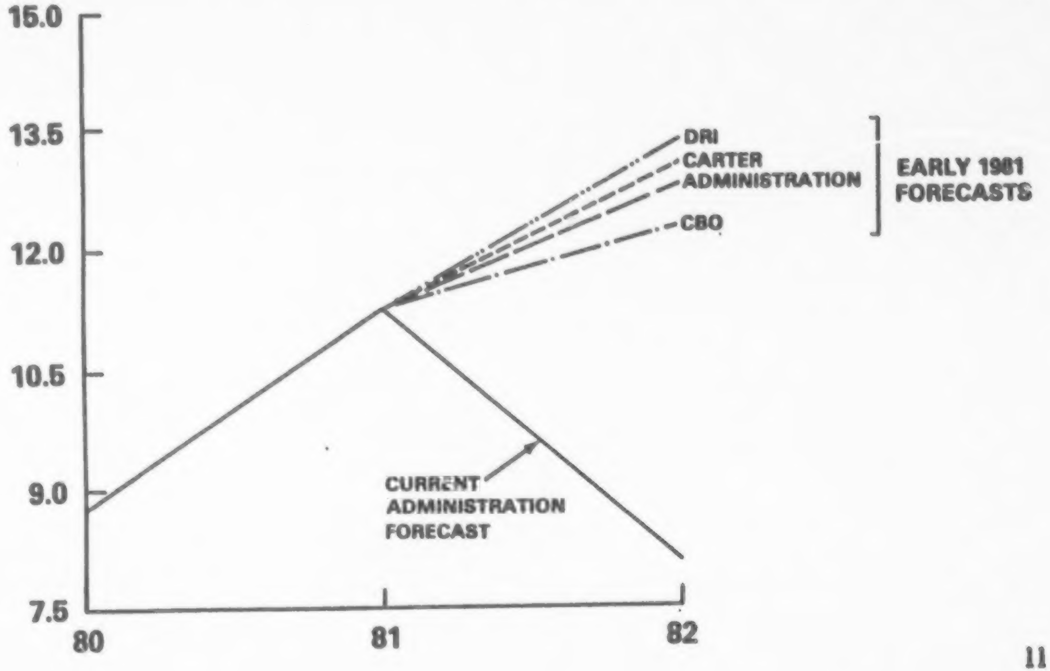
- ALL MAJOR FORECASTS ASSUMED THAT AFTER A FEW SLUGGISH QUARTERS IN 1981, ECONOMIC EXPANSION WOULD RESUME STRONGLY IN THE FALL AND INTO 1982. AS A CONSEQUENCE, THE 1982 GNP GROWTH RATE WAS OVER-ESTIMATED BY 50 - 65 PERCENT. WHEN COMBINED WITH HIGHER UNEMPLOYMENT, FY 82 BUDGET RECEIPTS AND UNEMPLOYMENT RELATED OUTLAY ESTIMATES WERE OFF BY LARGE MAGNITUDES.

- MOREOVER, THE LOWER BASE OF 1982 GNP AND THE RECESSION DRIVEN INCREASE IN THE FY 82 DEFICIT BOTH CARRY-OVER INTO FUTURE BUDGETS, WORSENING THE DEFICIT OUTLOOK:

	FY 1982	
	RECEIPT OVER-ESTIMATE	UNEMPLOYMENT RELATED OUTLAY UNDER-ESTIMATE
	(IN BILLIONS)	
CARTER - JANUARY	$38	$7
ADMINISTRATION - FEBRUARY	31	8
DRI	35	8
CBO - MARCH	30	6

GNP GROWTH FORECAST COMPARISON

(PERCENT CHANGE, YEAR OVER YEAR)

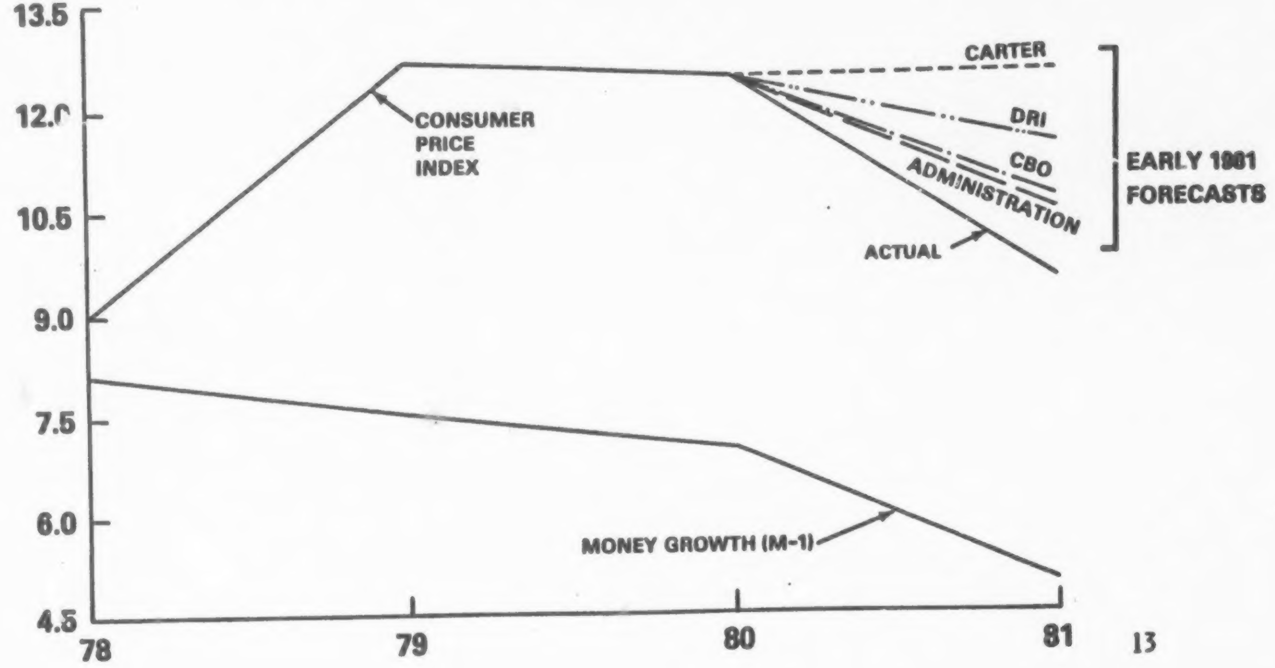


B) THE MONETARY LID ON NOMINAL GNP AND RECEIPT GROWTH: THE BUDGETARY IMPACT OF RECOVERY WITHOUT RE-IGNITING INFLATION.

- 1981 MARKED A FUNDAMENTAL DEPARTURE IN THE PREVIOUSLY UPWARD MOVEMENT OF MONEY, PRICES AND THE INFLATIONARY SPIRAL. GROWTH RATES TURNED ABRUPTLY DOWNWARD -- SUBSTANTIALLY MORE RAPIDLY THAN ANTICIPATED IN MOST FORECASTS EARLY LAST YEAR.
- ON A FOURTH-OVER-FOURTH QUARTER BASIS, THE MONEY SUPPLY GROWTH RATE DECLINED BY 30 PERCENT, THE CPI BY 25 PERCENT, AND THE PPI BY 42 PERCENT.
- THE DISINFLATION PROCESS IS CLEARLY UNDERWAY -- BUT THIS WELCOME IMPROVEMENT FOR THE ECONOMY IS A SERIOUS CHALLENGE TO BUDGETARY EQUILIBRIUM DURING THE TRANSITION.

GREATER THAN EXPECTED 1981 DECLINE IN MONEY GROWTH AND INFLATION

(PERCENT CHANGE, 4TH Q OVER 4TH Q)



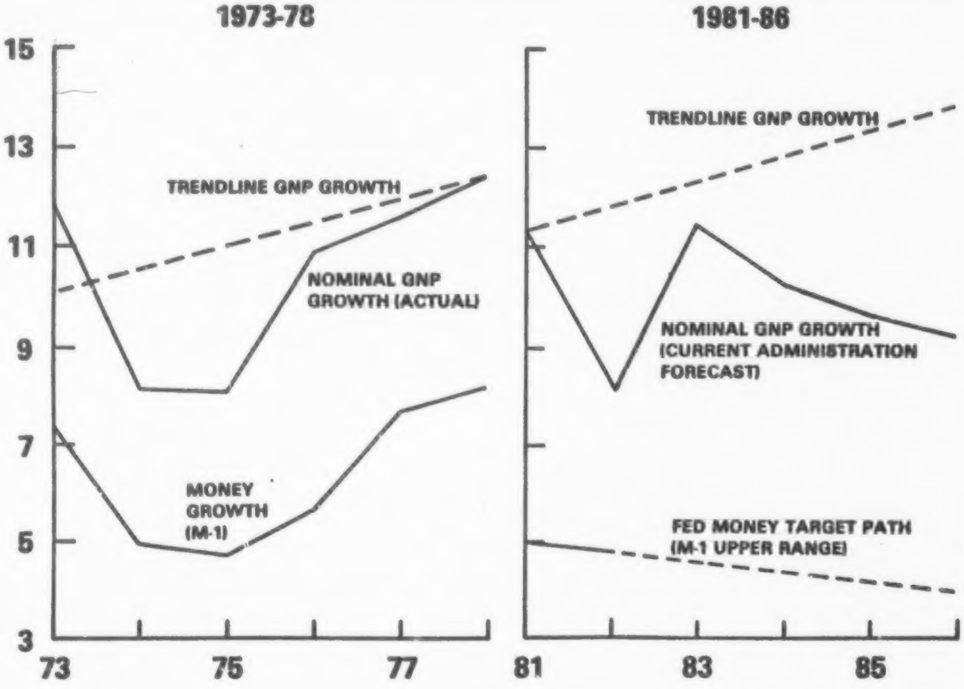
- THIS DRAMATIC PROGRESS IN SLOWING THE GROWTH OF MONEY AND INFLATION MUST BE PRESERVED -- BECAUSE PERMANENT ECONOMIC RECOVERY IS NOT POSSIBLE WITHOUT CONTINUED REDUCTION OF INFLATION. HOWEVER, PRESERVING THESE GAINS ON THE INFLATION FRONT WILL HAVE A PROFOUND IMPACT ON THE COURSE OF THE ECONOMY AND THE BUDGET OVER THE NEXT SEVERAL YEARS OF ECONOMIC RECOVERY AND BUDGET TRANSITION.

- UNLIKE THE PATTERN OF PREVIOUS RECOVERY PERIODS, MONEY SUPPLY GROWTH MUST BE HELD IN CHECK TO AVOID RE-IGNITING INFLATIONARY EXPECTATIONS AND UPWARD PRESSURE ON PRICES. THIS MEANS THAT THERE WILL BE A MONETARY LID ON THE GROWTH RATE OF NOMINAL GNP AND RECEIPTS DURING THE RECOVERY PERIOD.

- o BY CONTRAST, DURING THE 1975-78 RECOVERY/RECESSION CYCLE, MONEY SUPPLY GROWTH STEADILY ACCELERATED IN EACH RECOVERY YEAR, RISING FROM 5.0% IN 1975, TO 6.2% IN 1976, TO 8.2% BY 1977. THIS PERMITTED AN EQUALLY RAPID RECOVERY OF NOMINAL GNP GROWTH FROM 8% IN 1975 TO 12.4% BY 1978. THE CONSEQUENCE WAS RISING PRICES AND RAPID INFLATION-FUELED GROWTH OF BUDGETARY RECEIPTS.

- o DURING 1982-85, JUST THE OPPOSITE PATTERN WILL OCCUR IF ANTI-INFLATION MONETARY POLICY REMAINS ON TRACK. AFTER THE ANTICIPATED RECOVERY OF NOMINAL GNP IN 1983, THE NOMINAL GNP GROWTH RATE WILL STEADILY FALL -- RATHER THAN RISE -- AS INFLATION IS SQUEEZED OUT OF THE ECONOMY AND THE LID ON MONEY GROWTH IS MAINTAINED. THIS LID ON MONEY GROWTH, INFLATION AND NOMINAL GNP MEANS THERE WILL BE NO INFLATION-FUELED GROWTH OF BUDGET RECEIPTS AS HAS OCCURRED DURING RECENT BUSINESS CYCLES.

IMPACT OF MONETARY LID ON GNP GROWTH

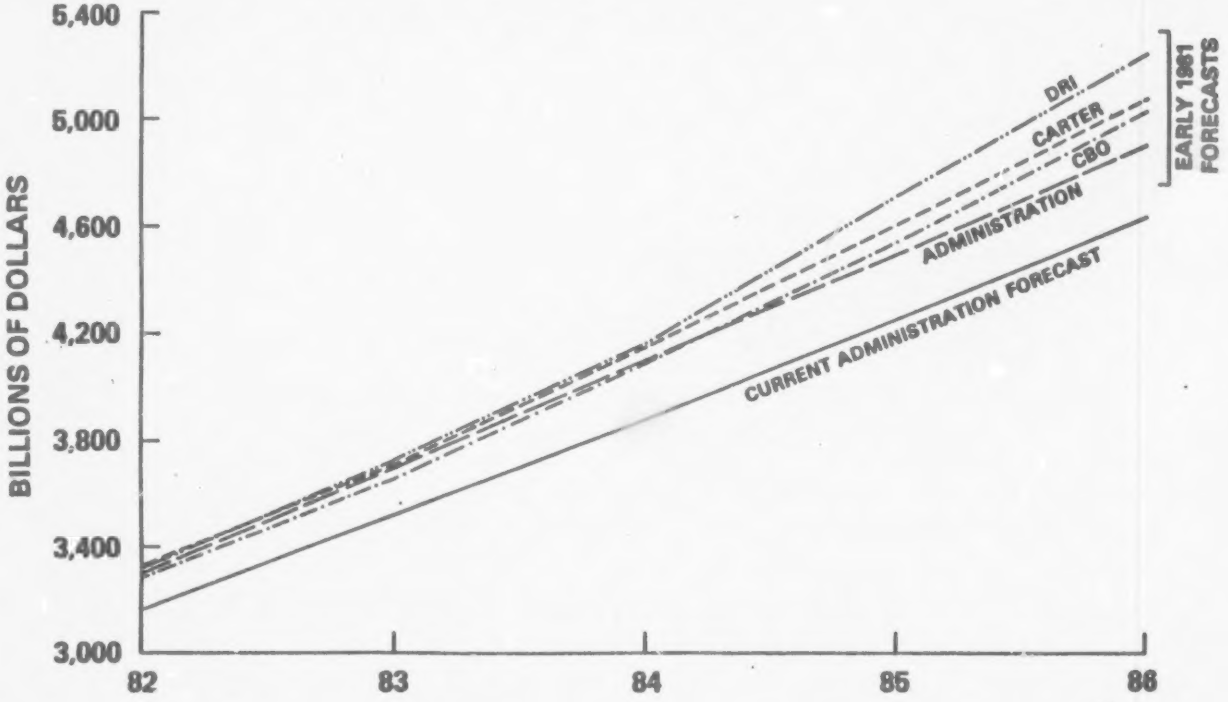


- THIS ANTI-INFLATION LID ON MONEY GROWTH, NOMINAL GNP AND BUDGET RECEIPTS WAS NOT ACCURATELY REFLECTED IN ANY OF THE EARLY 1981 FORECASTS, INCLUDING THAT OF THE ADMINISTRATION. IN COMBINATION WITH THE FAILURE TO PREDICT THE MUCH LOWER 1982 RECESSION GNP LEVEL, THIS MEANS THAT 1983-85 NOMINAL GNP LEVELS AND BUDGETARY RECEIPTS WERE DRASTICALLY OVER-ESTIMATED BY ALL FORECASTS.

MAGNITUDE OF GNP AND RECEIPT OVER-ESTIMATE

	1982	1983	1984	1985
I. EARLY 1981 OVER-ESTIMATE OF GNP RELATIVE TO CURRENT ADMINISTRATION FORECAST (BILLIONS)				
CARTER - JANUARY..............	$152	$194	$273	$353
CBO - MARCH..................	116	139	208	291
ADMINISTRATION - FEBRUARY.....	133	176	215	242
DRI - FEBRUARY................	150	198	286	467
II. EARLY 1981 OVER-ESTIMATE OF RECEIPTS RELATIVE TO CURRENT ADMINISTRATION FORECAST (BILLIONS)				
CARTER - JANUARY..............	$38	$57	$69	$84
CBO - MARCH..................	30	51	54	71
ADMINISTRATION - FEBRUARY.....	31	53	57	60
DRI - FEBRUARY................	35	60	69	106

CHANGE IN GNP OUTLOOK



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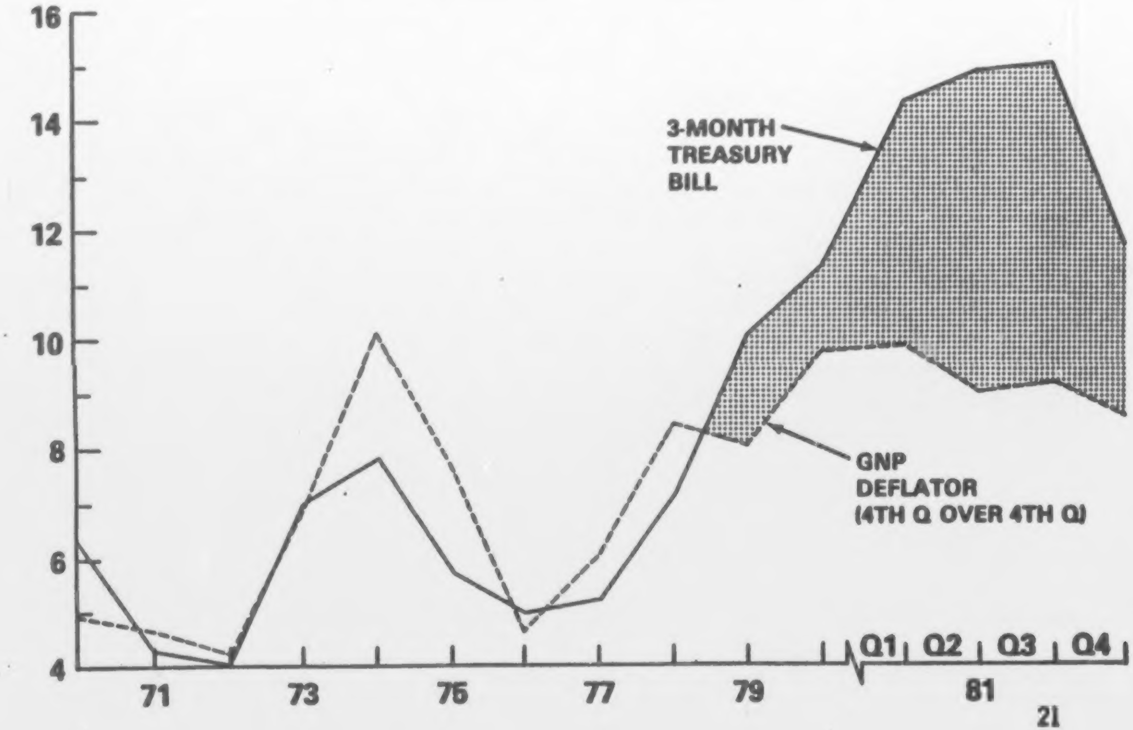
C) INTEREST PREMIUMS AND FINANCIAL MARKET TRANSITION

- THROUGHOUT THE 1970'S, THE RISE OF THE INTEREST RATES JUST PARALLELED THE RISE OF INFLATION AND IN MANY YEARS LAGGED BEHIND IT. IN THE T-BILL MARKET, THE AVERAGE REAL INTEREST RATE WAS ACTUALLY NEGATIVE -- MEANING THAT FOR A GOOD PART OF THE DECADE THE FEDERAL DEBT WAS FINANCED AT A NEGATIVE RATE OF RETURN.

- BUT AS THE INFLATION AND FINANCIAL DISORDER WORSENED IN 1979-80, THE FINANCIAL MARKETS ADJUSTED, LONG-TERM LENDING DRIED-UP AND HUGE PREMIUMS ABOVE THE INFLATION RATE APPEARED IN SECURITIES THROUGHOUT THE MATURITY SPECTRUM. THESE PREMIUMS REACHED UNPRECEDENTED SIZE THROUGHOUT 1981.

THE CHANGE IN TREASURY BILL — INFLATION RELATIONSHIP



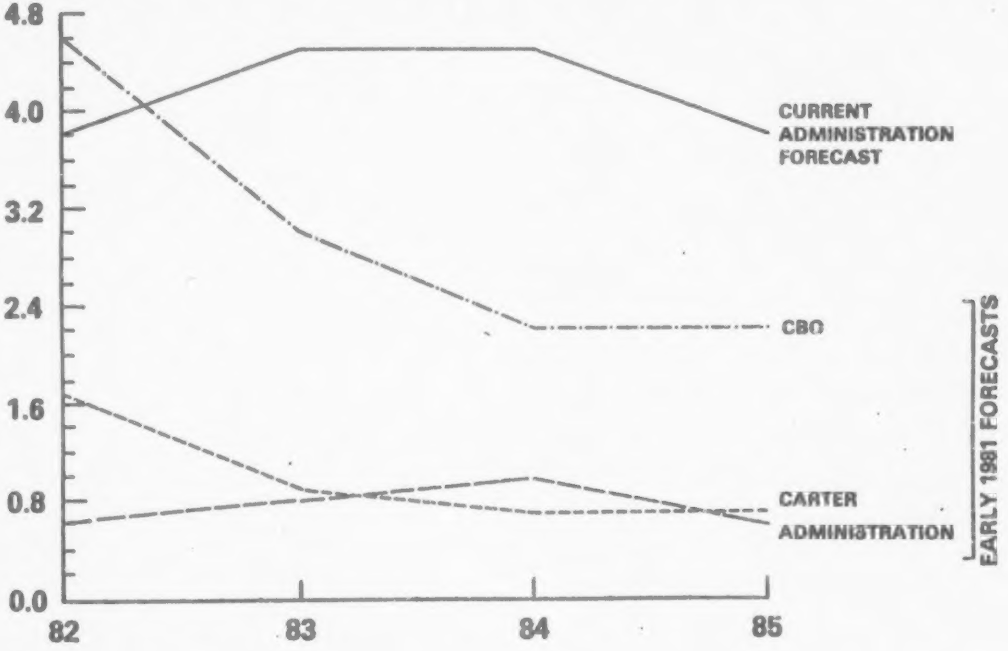
- FORECASTS ISSUED EARLY IN 1981, INCLUDING THE ADMINISTRATION FORECAST, GENERALLY DID NOT ANTICIPATE THE SIZE OF THESE PREMIUMS, NOR DID THEY ANTICIPATE THEY WOULD PERSIST OVER AN EXTENDED DURATION. AS A RESULT, INTEREST RATE LEVELS WERE SERIOUSLY UNDER-ESTIMATED ALONG WITH INTEREST RELATED OUTLAYS.

- IT NOW APPEARS THAT INTEREST RATE PREMIUMS WILL REMAIN "STICKY" DURING THE TRANSITION TO LOWER INFLATION. WHILE PROGRESS IN REDUCING INTEREST RATES CAN BE EXPECTED, IT WILL TAKE TIME TO RESTORE LONG-TERM FINANCIAL CONFIDENCE, REFINANCE SHORT-TERM BUSINESS AND HOUSEHOLD LIABILITIES AND TO BRING CREDIT DEMANDS, INCLUDING GOVERNMENT DEMANDS, AND AVAILABILITY INTO BALANCE.

- AS A CONSEQUENCE, THE ADMINISTRATION'S CURRENT FORECAST ASSUMES SUBSTANTIALLY LARGER INTEREST RATE PREMIUMS OVER THE NEXT SEVERAL YEARS THAN DID ALMOST ALL FORECASTS OF ONE YEAR AGO. RATHER THAN THE TRADITIONAL 1-2 PERCENT INFLATION/INTEREST SPREAD, THE CURRENT ADMINISTRATION FORECAST ASSUMES A 4% OR GREATER SPREAD OR PREMIUM THROUGH 1984, WITH A STEADY DECLINE THEREAFTER.

INTEREST RATE PREMIUM

(T-BILL RATE MINUS GNP DEFLATOR)



- GIVEN THE IMPROVING OUTLOOK FOR INFLATION, THE ADMINISTRATION FORECAST NEVERTHELESS PROJECTS A STEADY FALL IN THE INTEREST RATE FROM THE 11.7% T-BILL LEVEL PROJECTED FOR 1982 TO 9.5% BY 1984 AND LOWER THEREAFTER. THIS IS A SUBSTANTIALLY HIGHER PATH THAN PROJECTED LAST YEAR, AND WILL INCREASE INTEREST-RATE RELATED OUTLAYS BY $8 BILLION IN FY 82 AND $54 BILLION OVER FY 83-85.

- WHILE OTHER EARLY 1981 FORECASTS ASSUMED A HIGHER NOMINAL T-BILL RATE, THEY ALSO PROJECTED EXCESSIVE LEVELS OF INFLATION, NOMINAL GNP AND BUDGETARY RECEIPTS. WHEN ALL FORECAST FACTORS ARE REDUCED TO THE BOTTOM LINE -- ADDED DEFICIT AND INCREASED FUTURE YEAR DEBT -- THE CONCLUSION IS THE SAME: DEBT-SERVICE OUTLAYS DUE TO LARGER DEFICITS WILL BE SUBSTANTIALLY HIGHER EVEN IF THE ADMINISTRATION'S COMPLETE BUDGET SAVINGS PROGRAM IS ADOPTED.

OUTLAY INCREASE DUE TO ADDED DEBT RESULTING FROM ALL CHANGES BETWEEN EARLY 1981 FORECASTS AND THE CURRENT ADMINISTRATION FORECAST:

	FY83	FY84	FY85	TOTAL
CARTER - JANUARY..................	8	13	17	38
CBO - MARCH......................	6	8	10	24
ADMINISTRATION - FEBRUARY........	16	18	19	53
DRI - FEBRUARY..................	6	10	13	29

D) THE IMPACT OF ECONOMIC TRANSITION ON THE BUDGET OUTLOOK: CURRENT VS. ORIGINAL ADMINISTRATION PROJECTIONS

- THE FOREGOING MAKES CLEAR THAT THE ORIGINAL ADMINISTRATION ECONOMIC AND BUDGET FORECAST -- ALONG WITH ALL OTHERS ISSUED EARLY LAST YEAR -- DID NOT ANTICIPATE THE GALE-LIKE FORCES THAT A SLOW-DOWN IN MONEY, CREDIT AND NATIONAL INCOME GROWTH, AND THE RESULTING FINANCIAL AND ECONOMIC ADJUSTMENTS, WOULD UNLEASH ON THE BUDGET. IT IS NOW CLEAR THAT THE PROCESS OF DISINFLATION WORKS POWERFULLY AGAINST BUDGETARY EQUILIBRIUM -- AT LEAST FOR AN INTERIM PERIOD OF TIME -- AND THAT THE CHALLENGES OF FISCAL POLICY MANAGEMENT HAVE BECOME DECIDEDLY MORE INTENSE.

- IT IS THIS DISINFLATION PROCESS THAT IS LARGELY RESPONSIBLE FOR THE DRAMATIC DETERIORATION OF THE BUDGET OUTLOOK SINCE LAST YEAR.

- THE MORE ABRUPT THAN EXPECTED SLOW-DOWN IN MONEY GROWTH BETWEEN 1980 AND 1981 (7.2% IN 1980 VS 4.9% IN 1981) IN THE CONTEXT OF ACCUMULATED FINANCIAL WEAKNESS AND DEPRESSED LONG-TERM CAPITAL MARKETS -- TRIPPED THE ECONOMY INTO A TEMPORARY RECESSION AND CORRECTION OF UNDERLYING FINANCIAL AND ECONOMIC IMBALANCES.

- THE RESULTING HIGHER INTEREST RATES AND BORROWING HAVE ADDED $17 BILLION TO FY 82 OUTLAYS. THE RESULTING RECESSION HAS FURTHER REDUCED RECEIPTS BY $31 BILLION AND RAISED UNEMPLOYMENT RELATED OUTLAYS BY $8 BILLION COMPARED TO LAST YEAR'S PROJECTION. THIS $57 BILLION CHANGE DRIVEN BY ECONOMIC FORCES ACCOUNTS FOR THE ENTIRE INCREASE IN THE FY 82 DEFICIT FROM THE ORIGINAL PROJECTIONS. IN ADDITION, THE BUDGETARY SPILL-OVER INTO THE OUT-YEARS FROM THE FY 82 ECONOMIC AND BUDGET DETERIORATION COMPOUNDS THE PROBLEM OF REDUCING FUTURE DEFICITS.

- AS THE RECOVERY GATHERS FORCE THROUGH 1983 AND 1984, THE ANTI-INFLATION MONETARY POLICY WILL IMPOSE A "LID" ON THE RECOVERY OF NOMINAL GNP AND BUDGETARY RECEIPTS. THUS, THE BUDGET RECEIPT PROJECTION HAS BEEN SUBSTANTIALLY REDUCED SINCE LAST YEAR. RECEIPTS WILL BE $53 BILLION LOWER IN FY 83 AND $170 BILLION LOWER OVER FY 83-85. AS A CONSEQUENCE, INHERITED OR NEW SPENDING COMMITMENTS CANNOT BE FINANCED WITH INFLATION-FUELED GROWTH OF RECEIPTS DURING THE RECOVERY PERIOD, AS OCCURRED IN 1975-78 AND PREVIOUS BUSINESS CYCLES.

- THE $249 BILLION IN INDEXED PROGRAMS IN FY 1983 WILL RESPOND TO LOWER INFLATION -- BUT ONLY WITH A LAG DUE TO THE BASE PERIOD ADJUSTMENT MECHANISM. THE DIFFERENCE BETWEEN CONTEMPORANEOUS AND LAGGED ADJUSTMENT WILL INCREASE OUTLAYS BY $5 BILLION IN FY 83 AND $8 BILLION IN FY 85.

- THE RECESSION INDUCED RISE OF UNEMPLOYMENT TO THE 9% RANGE WILL ADD FURTHER PRESSURE TO THE BUDGET -- AS THE RECOVERY SPURRED DROP IN UNEMPLOYMENT WILL START FROM A HIGHER LEVEL AND TAKE LONGER TO REDUCE THAN ANTICIPATED LAST YEAR. SAFETY NET RELATED OUTLAYS WILL BE $14 BILLION HIGHER OVER FY 83-85 AS A CONSEQUENCE.

- THE RESTORATION OF FINANCIAL MARKET CONFIDENCE AND STABILITY WILL TAKE MORE TIME THAN PREVIOUSLY ANTICIPATED, RESULTING IN HIGHER INTEREST RATE PREMIUMS THAN PREVIOUSLY FORECAST. WHILE IT IS EXPECTED THAT T-BILL RATES WILL STEADILY FALL FROM CURRENT PEAKS, T-BILL LEVELS OVER FY 83-85 ARE NOW PROJECTED TO AVERAGE 260 BASIS POINTS HIGHER THAN PROJECTED LAST YEAR. THIS WILL INCREASE INTEREST-RATE RELATED OUTLAYS BY $15 BILLION IN FY 83 AND $54 BILLION OVER THE THREE-YEAR PERIOD.

- ALL OF THESE FORCES ACTING TOGETHER ADD TO CURRENT YEAR DEFICITS AND RAISE THE AMOUNT OF DEBT TO BE FINANCED IN OUT-YEARS. EVEN ASSUMING FULL ENACTMENT OF THE FY 83 BUDGET PROGRAM, ADDED INTEREST AND DEBT SERVICE OUTLAYS WILL REACH $31 BILLION IN FY 83 AND $107 BILLION OVER FY 83-85, COMPARED TO LAST YEAR'S FORECAST.

- THE HUGE DIFFERENCES IN BUDGET AND DEFICIT ESTIMATES SHOWN IN THE TABLE DUE TO THE CHANGE IN THE ECONOMIC OUTLOOK SINCE LAST FEBRUARY ARE NOT UNIQUE TO THE ADMINISTRATION'S ORIGINAL FORECAST, AS WAS DEMONSTRATED PREVIOUSLY.

COMPARISON OF FEBRUARY 1981 AND CURRENT ADMINISTRATION ECONOMIC ASSUMPTIONS
(CALENDAR YEAR, DOLLAR AMOUNTS IN BILLIONS)

	1981	1982	1983	1984	1985	1986
Nominal GNP:						
1981 forecast	2,920	3,293	3,700	4,098	4,500	4,918
1982 forecast	2,922	3,160	3,524	3,883	4,258	4,651
Real GNP (percent change):						
1981 forecast	1.1	4.2	5.0	4.5	4.2	4.2
1982 forecast	2.0	0.2	5.2	5.0	4.7	4.4
GNP Deflator (percent change):						
1981 forecast	9.9	8.3	7.0	6.0	5.4	4.9
1982 forecast	9.1	7.9	6.0	5.0	4.7	4.6
Interest Rate on 91-day Treasury Bills (percent):						
1981 forecast	11.1	8.9	7.8	7.0	6.0	5.6
1982 forecast	14.1	11.7	10.5	9.5	8.5	7.0
Unemployment Rate (percent).						
1981 forecast	7.8	7.2	6.6	6.4	6.0	5.6
1982 forecast	7.6	8.9	7.9	7.1	6.4	5.8

EFFECTS ON THE BUDGET OF CHANGES IN ECONOMIC ASSUMPTIONS SINCE MARCH 1981
(IN BILLIONS OF DOLLARS)

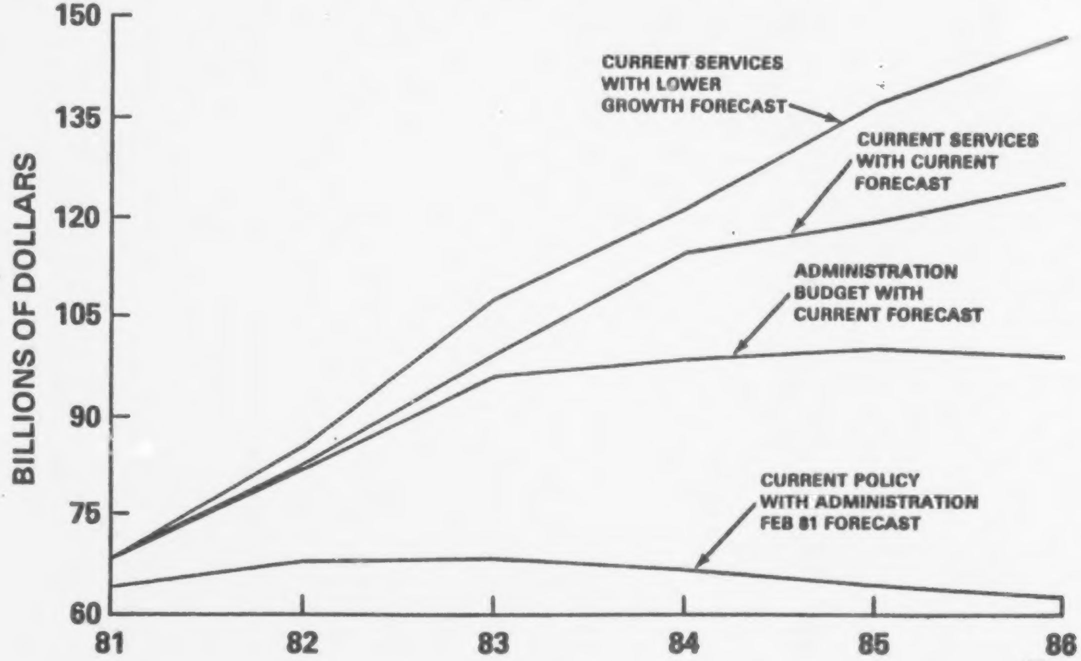
	1982	1983	1984	1985	1986
CURRENT BUDGET ESTIMATES ADJUSTED TO MARCH 1981 FORECAST:					
RECEIPTS	657.7	718.7	779.7	856.9	922.7
OUTLAYS	699.4	721.1	771.2	836.1	897.5
DEFICIT (-)	-41.7	-2.4	8.5	20.8	25.2
CHANGES DUE TO ECONOMIC ASSUMPTIONS:					
RECEIPTS	-31.0	-52.6	-56.7	-60.3	-61.7
OUTLAYS:					
INFLATION	1.5	-2.1	-5.7	-9.8	-11.9
UNEMPLOYMENT	7.9	7.4	4.4	2.3	0.9
INTEREST RATES AND DEFICITS	16.6	31.1	36.0	39.8	40.5
TOTAL	25.9	36.5	34.7	32.4	29.5
TOTAL INCREASE IN DEFICIT (-)	-56.9	-89.1	-91.4	-92.6	-91.2
CURRENT BUDGET ESTIMATES:					
RECEIPTS	626.8	666.1	723.0	796.6	861.0
OUTLAYS	725.3	757.6	805.9	868.5	927.0
DEFICIT (-)	-98.6	-91.5	-82.9	-71.9	-66.0

E) THE POTENTIAL EXPLOSION OF DEBT SERVICES COSTS

- CHANGES IN CURRENT AND EXPECTED ECONOMIC CONDITIONS ACCOUNT FOR THE HIGH DEFICITS PROJECTED EVEN AFTER THE ADMINISTRATION'S FY 83 BUDGET SAVINGS PROGRAM. BUT IT MUST BE CLEARLY RECOGNIZED THAT THESE DEFICIT INCREASING FORCES HAVE AN EXPLOSIVE POTENTIAL FOR FURTHER EXACERBATING THE BUDGET IMBALANCE IF DECISIVE AND COMPREHENSIVE DEFICIT REDUCTION ACTIONS ARE NOT IMPLEMENTED THIS YEAR.

- THE INCREASED INTEREST RATES AND DEBT FINANCING REQUIREMENTS FOR FY 83-85 ADD $94 BILLION TO THE PROJECTION OF NET INTEREST OUTLAYS COMPARED TO LAST FEBRUARY. IF NO ACTION IS TAKEN ON THE FY 83 BUDGET SAVINGS PROGRAM, NET INTEREST OUTLAYS OVER THE THREE YEARS WILL RISE BY ANOTHER $33 BILLION. AND IF ECONOMIC PERFORMANCE WEAKENS UNDER THE BURDEN OF THESE DEBT FINANCING REQUIREMENTS TO THE LOWER-GROWTH/HIGHER INFLATION SCENARIO DESCRIBED ON PAGE 4 -- ANOTHER $37 BILLION WOULD BE ADDED TO DEBT SERVICE COSTS OVER THE NEXT THREE YEARS.

POTENTIAL EXPLOSION OF DEBT — SERVICE OUTLAYS



IV. THE FISCAL POLICY ALTERNATIVES CONSIDERED BY CONGRESS LAST YEAR WOULD HAVE HAD A SIMILAR IMPACT ON THE CURRENT BUDGET OUTLOOK: SIMILAR, LARGE CURRENT SERVICES DEFICITS RESULT FROM EITHER THE ADMINISTRATION PROGRAM AS ADOPTED OR THE HOUSE WAYS AND MEANS AND BUDGET COMMITTEE TAX AND SPENDING POLICY ALTERNATIVES THAT WERE REJECTED.

- THE TABLE BELOW PROVIDES A CURRENT SERVICES PROJECTION OF MAJOR SPENDING AND TAX POLICY OPTIONS CONSIDERED AND REJECTED BY THE CONGRESS LAST YEAR COMPARED TO THE CURRENT SERVICES PROJECTION OF THE ADMINISTRATION PROGRAM AS ENACTED. BOTH BUDGET PROJECTIONS ARE BASED ON THE CURRENT ADMINISTRATION ECONOMIC FORECAST.

- HAD THE FIRST BUDGET RESOLUTION SPENDING POLICY RECOMMENDATIONS PROPOSED BY THE HOUSE BUDGET COMMITTEE LAST YEAR BEEN ADOPTED, AGGREGATE CURRENT SERVICES OUTLAY PROJECTIONS WOULD HAVE BEEN SIMILAR -- EXCEPT FOR A MODEST RE-ALLOCATION OF OUTLAYS FROM DEFENSE TO NON-DEFENSE PROGRAMS.

o HAD THE WAYS AND MEANS COMMITTEE TAX BILL HAVE BEEN ADOPTED, THE THIRD-YEAR OF THE INDIVIDUAL RATE CUT WOULD NOT LIKELY BE TRIGGERED IN JANUARY 1984 AS PROVIDED BY THE BILL. NEVERTHELESS, DUE TO OTHER PROVISIONS OF THE WAYS AND MEANS ALTERNATIVE THE FY 82-84 STATIC REVENUE COST WOULD HAVE BEEN SIMILAR:

	($ BILLIONS)
ECONOMIC RECOVERY TAX ACT REVENUE COST, FY 82-84	$-269
WAYS AND MEANS TAX ALTERNATIVE FY 82-84 WITHOUT THIRD YEAR RATE CUT	$-253

- AS A CONSEQUENCE, CURRENT SERVICES DEFICIT PROJECTIONS FOR FY 82-84 ARE NEARLY IDENTICAL WHEN BASED ON COMMON ECONOMIC ASSUMPTIONS. IN BOTH CASES, A LARGE, UNANTICIPATED FISCAL PROBLEM LOOMS ON THE HORIZON DUE TO CHANGED ECONOMIC CIRCUMSTANCES AND OUTLOOK.

- THE DEFICIT CAN BE REDUCED IF THE DEBATE FOCUSES ON THE COMMON PROBLEM AT HAND AND THE POTENTIAL BUDGET SAVINGS OPTIONS AVAILABLE. RE-OPENING THE DEBATE ON PAST POLICY CHOICES -- BOTH OF WHICH APPROPRIATELY AND IRREVERSIBLY MOVED THE NATION FORWARD ON A CONSTRUCTIVE PATH OF LOWER TAXES AND REDUCED SPENDING GROWTH -- WILL NEITHER SOLVE NOR EXPLAIN OUR CURRENT FISCAL POLICY CHALLENGES.

CURRENT SERVICES BUDGET ESTIMATES: ENACTED ADMINISTRATION PROGRAM VS. 1981 CONGRESSIONAL ALTERNATIVES

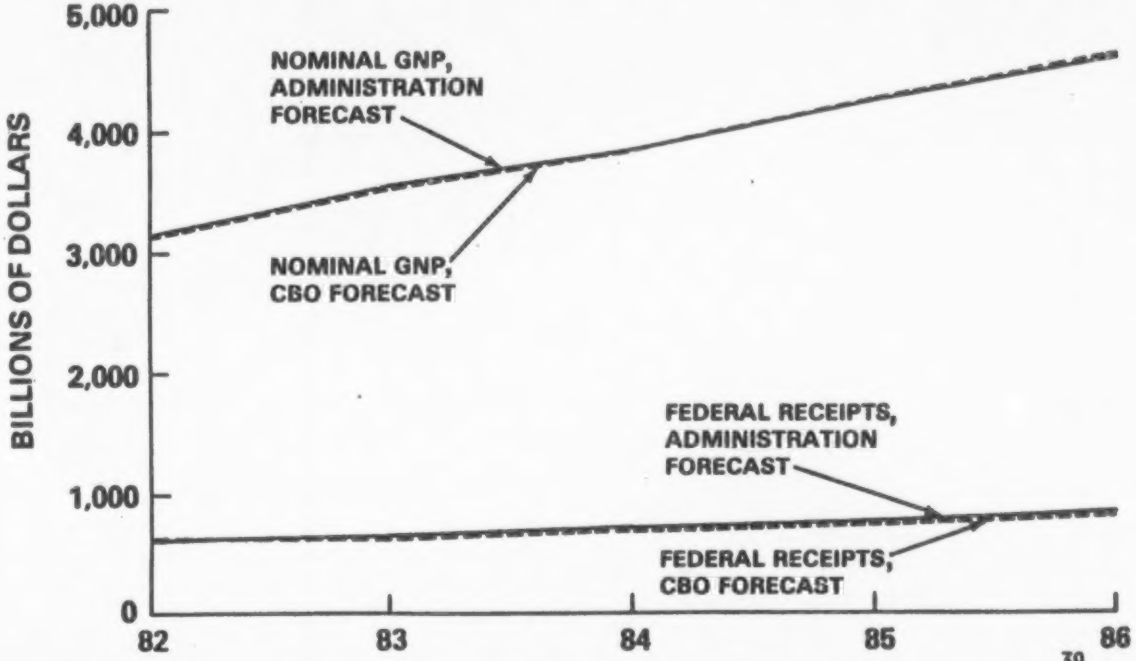
(BILLIONS OF $)

	FY-82	FY-83	FY-84
OUTLAYS:			
ADMINISTRATION CURRENT SERVICES ESTIMATE:	728	799	869
POLICY DIFFERENCES IN 1981 HBC FIRST BUDGET RESOLUTION:			
NON-DEFENSE INCREASES	+7	+7	+7
DEFENSE REDUCTIONS	--	-5	-6
CURRENT SERVICES ESTIMATE WITH HBC SPENDING POLICY ALTERNATIVE	735	801	870
RECEIPTS:			
ADMINISTRATION CURRENT SERVICES ESTIMATE:	626	653	704
POLICY DIFFERENCES IN 1981 WAYS AND MEANS TAX ALTERNATIVE	+ 2	- 2	+17
CURRENT SERVICES RECEIPTS WITH WAYS AND MEANS TAX ALTERNATIVE	628	651	721
DEFICIT:			
ADMINISTRATION CURRENT SERVICES DEFICIT	-102	-147	-167
CURRENT SERVICES DEFICIT WITH HBC SPENDING AND WAYS AND MEANS TAX ALTERNATIVE	-107	-150	-149

V. THE 1982 FORECAST ISSUES: CBO VS. ADMINISTRATION ASSUMPTIONS

- o ON THE MAJOR VARIABLE WHICH DRIVES THE BUDGET AND DEFICIT -- NOMINAL GNP -- THERE ARE NO SIGNIFICANT DIFFERENCES BETWEEN THE ADMINISTRATION AND CBO FORECASTS. GNP LEVELS AND CURRENT LAW RECEIPT ESTIMATES ARE NEARLY IDENTICAL FOR FY 82-84, WITH CBO SOMEWHAT LOWER IN FY 85. AS NOTED PREVIOUSLY, BOTH EMBODY SUBSTANTIAL DOWNWARD ESTIMATES FROM LAST YEAR'S ASSUMPTIONS.

IMPACT OF ADMINISTRATION AND CBO FORECASTS: DIFFERENCE ON GNP AND RECEIPTS



- A SIGNIFICANT DIFFERENCE IN TERMS OF BUDGETARY IMPACT IS FOUND IN THE COMPOSITION OF NOMINAL GNP -- THE SPLIT BETWEEN REAL GROWTH AND INFLATION. ESSENTIALLY, CBO ASSUMES A SIGNIFICANTLY LOWER REAL GROWTH RATE AND A HIGHER INFLATION RATE.

- FOR THE SIX INITIAL RECOVERY QUARTERS BEGINNING IN 1982:3, THE ADMINISTRATION AND CBO GNP GROWTH RATES COMPARE WITH HISTORICAL RECOVERY PERIODS AS FOLLOWS:

	AVERAGE REAL GNP GROWTH, SIX INITIAL RECOVERY QUARTERS
ADMINISTRATION	5.4%
CBO	4.5
1975 - 1976	5.3
1970 - 1971	5.6
1961 - 1962	6.0
1958 - 1959	5.7
AVERAGE, ALL POST-WAR RECOVERIES	5.6%

- FOR THE ENTIRE 22 QUARTER PERIOD OF REAL EXPANSION BEGINNING IN 1982:2 THROUGH 1987, THE ADMINISTRATION AND CBO FORECASTS COMPARE AS FOLLOWS:

	22 QUARTER AVERAGE REAL GROWTH (%)
ADMINISTRATION	4.7
CBO	3.1
AVERAGE, 1947 - 1981	3.5
AVERAGE, 1961 - 1966	5.4

- COMPARED WITH ALL TWENTY-TWO-QUARTER PERIODS (118 SEPARATE OBSERVATIONS) BETWEEN 1947 - 1981, THE CBO AND ADMINISTRATION REAL GROWTH FORECASTS COMPARE AS FOLLOWS:

	NUMBER OF PERIODS ABOVE	NUMBER OF PERIODS BELOW
ADMINISTRATION	22	96
CBO	73	45

- BOTH THE ADMINISTRATION AND CBO FORECASTS ASSUME SUBSTANTIAL INTEREST PREMIUMS OVER THE 1983-85 PERIOD. HOWEVER, SINCE THE CBO FORECAST ASSUMES LOWER GROWTH AND HIGHER INFLATION, CBO T-BILL LEVELS ARE SUBSTANTIALLY HIGHER IN EACH OF THE THREE YEARS:

INTEREST PREMIUM (%)

	1983	1984	1985
CBO........................	5.9	4.7	3.4
ADMINISTRATION............	4.5	4.5	3.8

T-BILL LEVEL (%)

	1983	1984	1985
CBO........................	13.2	11.3	9.4
ADMINISTRATION............	10.5	9.5	8.5

- THE OVERALL IMPACT ON THE BUDGET AND DEFICIT PROJECTIONS OF THESE DIFFERENCES IN FORECAST ASSUMPTIONS IS MODEST FOR FY 82-83, BUT OF SIGNIFICANT MAGNITUDE FOR FY 83-84:

	FY 82	FY 83	FY 84	FY 85
ADMINISTRATION DEFICIT ESTIMATE......	-98.6	-91.5	-82.9	-71.9
WITH CBO ECONOMIC ASSUMPTIONS........	-104.5	-98.8	-104.7	-103.7
DIFFERENCE......................	5.9	7.3	21.8	31.8

- WHILE THESE CURRENT FORECAST DIFFERENCES HAVE SIGNIFICANT BUDGETARY IMPACT IN THE OUT-YEARS, THEIR MAGNITUDE IS SUBSTANTIALLY OVER-SHADOWED BY THE DEFICIT IMPACT OF THE ADMINISTRATION'S FIVE-PART BUDGET SAVINGS PLAN. THUS, FORECAST ISSUES ARE IMPORTANT, BUT THE ULTIMATE SIZE OF THE DEFICIT AND ITS IMPACT ON THE ECONOMIC RECOVERY WILL DEPEND UPON SUCCESSFUL POLICY ACTION TO REFORM ENTITLEMENTS, HOLD-DOWN DISCRETIONARY SPENDING, ELIMINATE TAX LOOPHOLES AND IMPLEMENT USER FEES AND MANAGEMENT INITIATIVES:

	FY-83	FY-84	FY-85	TOTAL FY-83-85
DEFICIT ADD-ON DUE TO CBO ECONOMIC ASSUMPTIONS....................	+7	+22	+32	+61
DEFICIT REDUCTION DUE TO ADMINISTRATION FIVE-PART BUDGET SAVINGS PROGRAM........	-56	-84	-99	-239

ADMINISTRATION BUDGET [illegible]
CBO ECONOMIC ASSUMPTIONS

	82	83	84	85
I. OUTLAYS				
ADMINISTRATION OUTLAYS	725.3	757.6	805.9	868.5
RE-ESTIMATES FOR CBO ASSUMPTIONS:				
HIGHER INTEREST RATES	1.0	1.5	11.1	9.2
HIGHER DEBT	0.2	1.1	2.4	5.3
HIGHER UNEMPLOYMENT	--	1.2	2.2	4.7
HIGHER INFLATION	--	1.2	5.5	14.9
OUTLAYS WITH CBO ASSUMPTIONS 1/	726.5	762.6	827.1	902.6
II. RECEIPTS				
ADMINISTRATION RECEIPTS	626.8	666.1	723.0	796.6
RE-ESTIMATES FOR CBO ECONOMIC ASSUMPTIONS	-4.8	-2.3	-0.6	2.3
RECEIPTS WITH CBO ASSUMPTIONS 1/	622.0	663.8	722.4	798.9
III. DEFICIT				
ADMINISTRATION ESTIMATE	-98.6	-91.5	-82.9	-71.9
RE-ESTIMATE WITH CBO ECONOMIC ASSUMPTIONS 1/	-104.5	-98.8	-104.7	-103.7

1/ NOTE: OMB ESTIMATES FOR ECONOMIC ASSUMPTION DIFFERENCES ONLY. DOES NOT REFLECT DIFFERENCES IN TECHNICAL ESTIMATES.

VI. THE PRESIDENT'S FY 83 BUDGET SAVINGS PROGRAMS

- IN AN EFFORT TO MEET HEAD-ON THIS DETERIORATION OF THE FISCAL SITUATION, THE PRESIDENT'S FY 83 BUDGET PROPOSES A BALANCED, COMPREHENSIVE AND SUBSTANTIAL PROGRAM TO CLOSE THE UNANTICIPATED BUDGET GAP. THE BUDGET SAVINGS PROGRAM:
  - REDUCES THE FY 83 DEFICIT BY $56 BILLION -- WITH ANNUAL SAVINGS RISING TO $99 BILLION BY FY 85.
  - REDUCES THE OVERALL CURRENT SERVICES DEFICIT BY $239 BILLION OR 50% OVER THE FY 83-85 PERIOD.
  - ENSURES THAT THE DEFICIT WILL DECLINE STEADILY FROM THE FY 82 RECESSION PEAK, AND THAT DEFICITS DURING THE RECOVERY PERIOD FY 83-85 WILL NOT EXCEED HISTORIC LEVELS RELATIVE TO GNP OR TO TOTAL CREDIT AND CAPITAL AVAILABILITY.

FIVE-PART BUDGET SAVINGS PLAN
— FY '83-85 —
(BILLIONS OF DOLLARS)

	FY '83	FY '84	FY '85	TOTAL	SHARE
ENTITLEMENT REFORMS	11.7	17.1	22.8	51.6	22%
USER FEES	2.5	3.5	3.8	9.8	4%
DISCRETIONARY PROGRAM CUTS	14.2	26.1	35.3	75.6	32%
MANAGEMENT INITIATIVES	20.3	24.0	23.9	68.2	28%
TAX REVISIONS	7.2	13.5	13.5	34.1	14%
TOTAL	55.9	84.1	99.3	239.3	100%

KEY ENTITLEMENT REFORMS

MEDICAL CARE

- o PROVIDER REIMBURSEMENT SAVINGS
- o CO-PAYMENTS AND INDEXING OF DEDUCTIBLE
- o FEDERAL EMPLOYEE COVERAGE -- HI TAX
- o PRO-COMPETITION COST CONTAINMENT PLAN -- LATER TRANSMITTAL

CASH ASSISTANCE

- o SSI -- MEDICAL DISABILITY AND 24 MONTH PROGNOSIS
- o AFDC -- TIGHTEN WORKFARE, BROADEN INCOME TESTS

FEDERAL RETIREMENT

- o LOWER OF FEDERAL PAY RAISE OR CPI
- o LIMIT COLA TO LESS THAN CPI WHERE ANNUITIES EXCEED CURRENT RETIREMENT LEVELS

KEY ENTITLEMENT REFORMS
(CONTINUED)

FOOD STAMPS AND NUTRITION

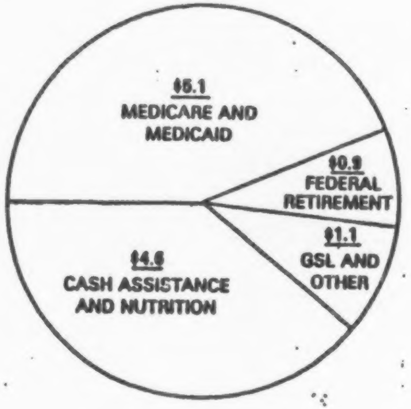
- o RAISE INCOME CONTRIBUTION FOR FOOD FROM 30% TO 35%
- o ELIMINATE EARNED INCOME DISREGARD
- o BENEFIT ROUNDING, MANDATORY JOB SEARCH
- o ELIMINATE SPECIAL MILK AND SUMMER FEEDING

GUARANTEED STUDENT LOANS

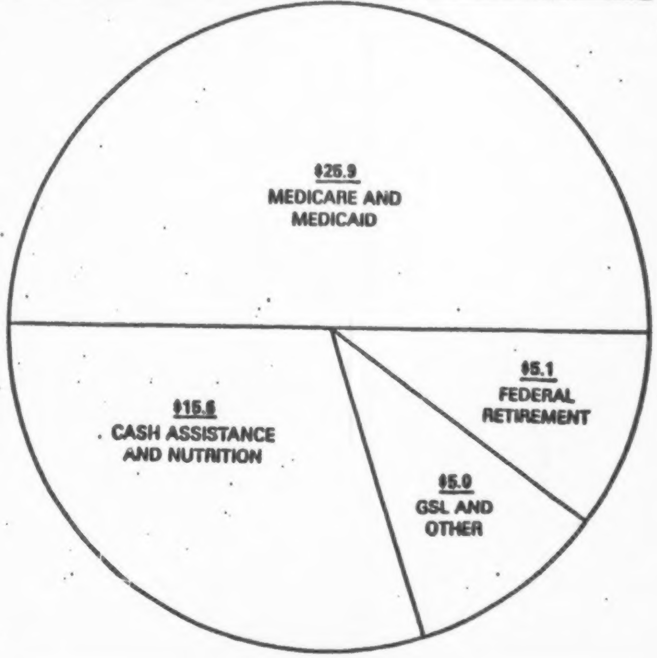
- o RAISE ORIGINATION FEE FROM 5% TO 10%
- o TIGHTEN AND APPLY NEEDS TEST TO ALL APPLICANTS
- o ELIMINATE FULL INTEREST SUBSIDY FOR GRADUATE STUDENTS

ENTITLEMENT REFORMS

(BILLIONS OF DOLLARS)



FY '83: $11.7



FY '83-85: $51.6

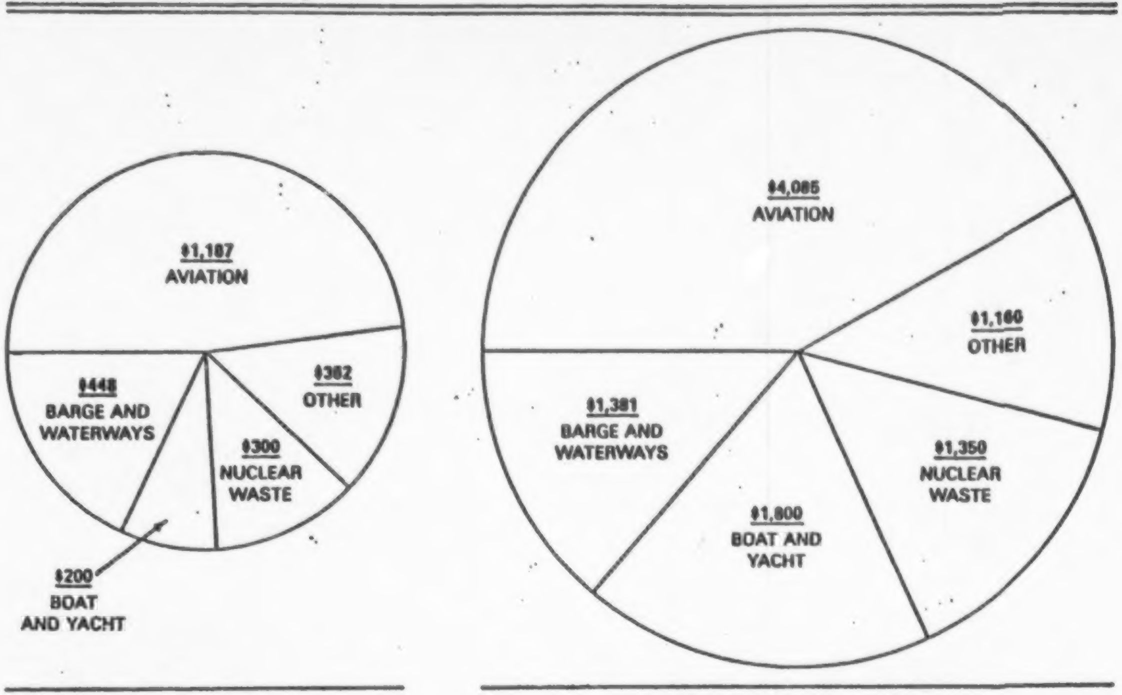
USER FEE INITIATIVE

FIFTEEN NEW, INCREASED OR RE-PROPOSED USER FEES WOULD YIELD $2.5 BILLION IN FY 83 RISING TO $3.8 BILLION BY FY 85.

- AVIATION USER FEES TO RECOVER 85% OF AIR TRAFFIC CONTROL SYSTEM COSTS FINANCED WITH 8% PASSENGER TICKET TAX AND INCREASED GENERAL AVIATION GASOLINE AND JET FUEL TAXES
- CORPS OF ENGINEERS NAVIGATION FEES TO RECOVER NEW CONSTRUCTION AND MAINTENANCE EXPENSES FOR COMMERCIAL PROJECTS
- COMMERCIAL NUCLEAR WASTE DISPOSAL TO ESTABLISH AN INDEPENDENT AND SELF-FINANCING WASTE DISPOSAL OPERATION -- $300 MILLION IN INITIAL YEAR
- COAST GUARD USER FEES FOR LICENSES, INSPECTIONS, NAVIGATION AIDS AND SEARCH AND RESCUE MISSIONS
- RECREATION FEES FOR PARK ENTRY AND USE OF FACILITIES
- PATENTS AND TRADEMARK FEES TO COVER APPLICATION PROCESSING COSTS AND TO OFFSET THE COSTS OF PATENT AND TRADEMARK OFFICE (PTO).

USER FEES

(MILLIONS OF DOLLARS)



FY '83: $2,487

FY '83-'85: $9,776

HIGHLIGHTS OF DISCRETIONARY PROGRAM SAVINGS

EDUCATION, EMPLOYMENT AND TRAINING

- CONSOLIDATION OF EMPLOYMENT AND TRAINING PROGRAMS INTO BLOCK GRANT -- $1.9 BILLION SAVINGS
- TARGET PELL GRANTS TO LOWER INCOME STUDENTS
- REDUCE CAMPUS BASED AID PROGRAMS -- FOCUSE ON WORK-STUDY
- IMPACT AID -- LIMIT PAYMENTS TO "A" STUDENTS ONLY
- ELEMENTARY AND SECONDARY EDUCATION -- REDUCE GRANTS BY $1.8 BILLION
- VOCATIONAL EDUCATION AND REHABILITATION -- REDUCE GRANTS BY ONE-THIRD

HOUSING

- ELIMINATE NEW SECTION 8 STARTS EXCEPT FOR 10,000 ELDERLY UNITS AND REPLACE WITH LESS EXPENSIVE CERTIFICATES -- 107,000 IN FY 83
- 30% RENT BURDEN FOR NEW TENANTS; COUNT FOOD STAMP INCOME, ELIMINATE NEGATIVE RENT PAYMENT

HIGHLIGHTS OF DISCRETIONARY PROGRAM SAVINGS

(CONTINUED)

INCOME SECURITY, SOCIAL SERVICES

- CONSOLIDATE WIC WITH MCH
- RE-TARGET LOW-INCOME ENERGY AID TO COLDER STATES
- REDUCE TITLE XX GRANTS BY 18%
- CHILD WELFARE BLOCK GRANT
- NO FUNDING FOR LEGAL SERVICES

TRANSPORTATION

- REDUCE FUNDING FOR NON-INTERSTATE HIGHWAYS BY 21%
- REDUCE MASS TRANSIT OPERATING SUBSIDIES BY 38%
- REDUCE AMTRAK BY $185 MILLION -- INCREASED COST ABSORPTION BY LABOR, PASSENGERS, LOCALITIES

HIGHLIGHTS OF DISCRETIONARY PROGRAM SAVINGS

(CONTINUED)

ENERGY AND NATURAL RESOURCES

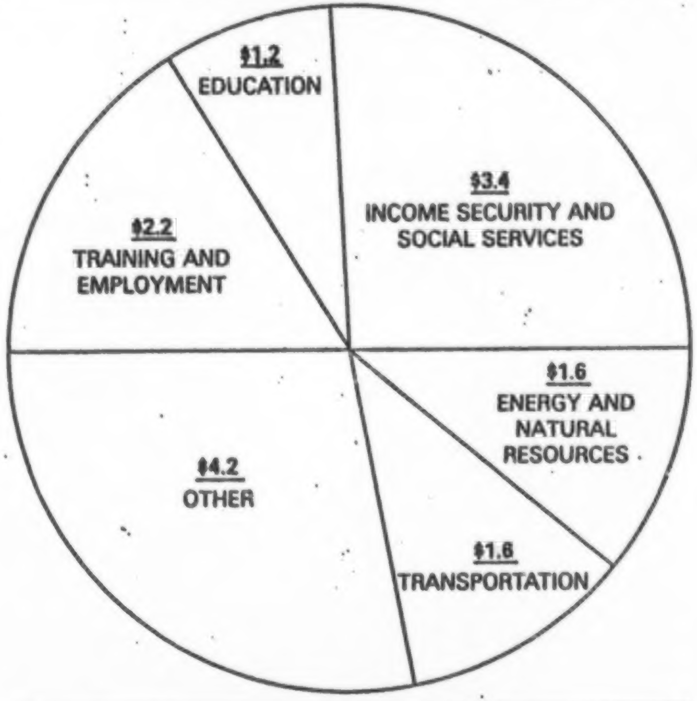
- ELIMINATE REMAINING NON-NUCLEAR DEVELOPMENT, DEMONSTRATION AND COMMERCIALIZATION FUNDING -- SAVE $900 MILLION
- TERMINATE STATE CONSERVATION AND LOW-INCOME WEATHERIZATION
- CUT SOIL CONSERVATION GRANTS 33%

BUSINESS SUBSIDIES

- EXPORT-IMPORT BANK DIRECT LOANS 18% BELOW CURRENT SERVICES
- NO NEW MARITIME CONSTRUCTION OR OPERATING SUBSIDY CONTRACTS

DISCRETIONARY PROGRAMS

(BILLIONS OF DOLLARS)



TOTAL: $14.2

MANAGEMENT INTIATIVES

IRS COLLECTION AND ENFORCEMENT

- 5200 ADDITIONAL IRS STAFF TO REDUCE DELINQUENT ACCOUNT BACKLOG, INCREASE AUDIT COVERAGE OF LARGE COMPANIES, AND IDENTIFY NON-FILERS
- WITHHOLDING OF TAXES ON INTEREST AND DIVIDENDS
- ACCELERATION OF CORPORATE TAX COLLECTION TO 90% OF ESTIMATED LIABILITY

FEDERAL PAY RESTRAINT

- LIMIT PAY RAISE TO 5%

ACCELERATED OFF-SHORE LEASING

- THE ADMINISTRATION'S ACCELERATED OCS LEASING PROGRAM IS EXPECTED TO RESULT IN AN AVERAGE OF 5.7 MILLION ACRES PER YEAR IN SALES, WHICH IS MORE THAN DOUBLE THE AVERAGE UNDER THE CARTER SCHEDULE
- WILL RESULT IN INCREASED BONUS PAYMENTS THAT NEARLY DOUBLE PROJECTED RECEIPTS FROM OCS BONUS AND ROYALTY PAYMENTS TO A TOTAL OF $18 BILLION IN FY 83

MANAGEMENT INITIATIVES
(CONTINUED)

SURPLUS PROPERTY DISPOSAL

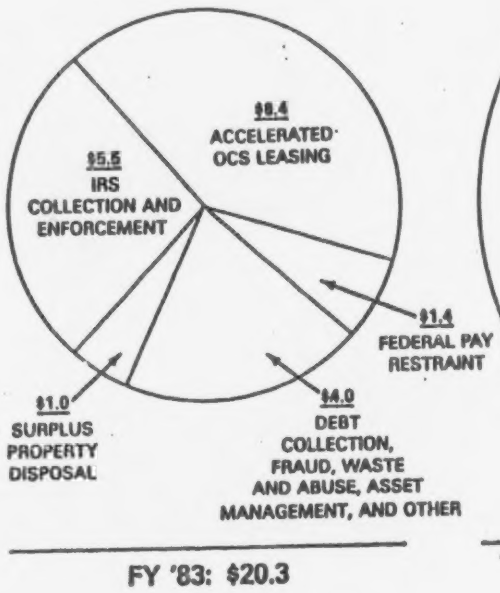
- SURPLUS GSA PROPERTY TRANSFERRED TO OTHER AGENCIES ONLY AT MARKET VALUE, NOT FREE AS CURRENT PRACTICE
- HIGH-LEVEL PROPERTY REVIEW BOARD TO OVERSEE REAL PROPERTY MANAGEMENT, IDENTIFICATION OF UNNEEDED HOLDINGS AND SPEEDY DISPOSAL WHEREVER POSSIBLE
- DISPOSE OF TENS OF MILLIONS OF ACRES OF PUBLIC LAND WITH NO UNIQUE WILDERNESS, RECREATIONAL OR HISTORIC SIGNIFICANCE, INCLUDING PARCELS ADJACENT TO NEWLY URBANIZED AREAS, AND SMALL, ISOLATED TRACTS TOO COSTLY TO MANAGE

DEBT COLLECTION

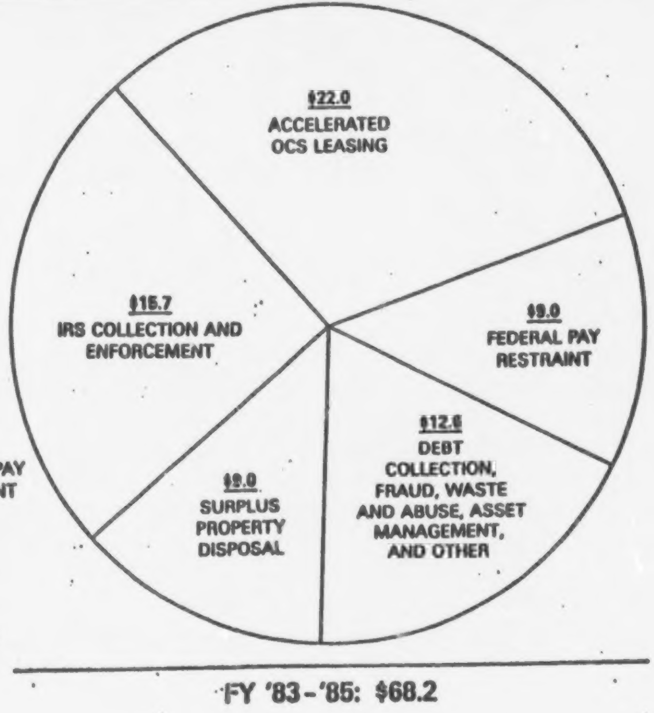
- 24 AGENCIES WILL HAVE COMPREHENSIVE COLLECTION PLANS AND TARGETS — INCLUDING INCREASED TRAINING, ACCOUNTABILITY AND IMPROVED TECHNIQUES
- NEW LEGISLATIVE AUTHORITY INCLUDING FURNISHING OF SOCIAL SECURITY NUMBERS, BROADER AUTHORITY TO CONTRACT OUT, POWER TO ASSESS INTEREST AND PENALTIES ON OVERDUE ACCOUNTS AND TO REFER INFORMATION ON DELINQUENT DEBTORS TO CREDIT BUREAUS

MANAGEMENT INITIATIVES

(BILLIONS OF DOLLARS)



FY '83: $20.3



FY '83-'85: $68.2

TAX REVISIONS

CHANGES ARE DESIGNED TO ELIMINATE ABUSES, REMOVE OBSOLETE INCENTIVES, CORRECT UNINTENDED LOOPHOLES, AND REQUIRE PROFITABLE BUSINESS TO CONTRIBUTE AT LEAST SOME MINIMUM FAIR SHARE.

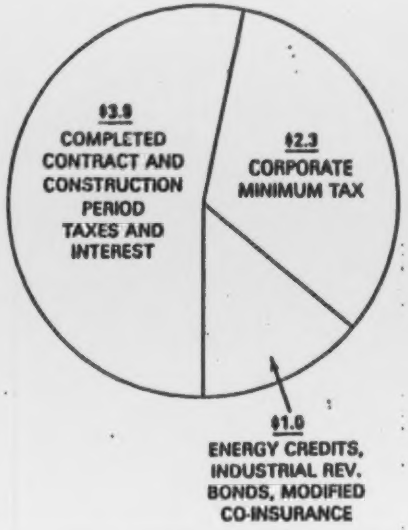
- DISALLOW COMPLETED CONTRACT METHOD OF TAX ACCOUNTING. TAXPAYERS WILL BE REQUIRED TO USE EITHER THE PERCENTAGE OF COMPLETION METHOD OR THE PROGRESSIVE PAYMENT METHOD OF ACCOUNTING FOR LONG-TERM CONTRACTS.
- REPEAL ALL BUSINESS ENERGY TAX SUBSIDIES AND SPECIAL PROVISIONS ALLOWING STATES AND LOCALITIES TO ISSUE TAX-EXEMPT INDUSTRIAL DEVELOPMENT BONDS TO FINANCE CERTAIN ENERGY PROJECTS.
- ASSETS FINANCED WITH TAX-EXEMPT REVENUE BONDS ISSUED AFTER 1982 MUST BE DEPRECIATED USING THE STRAIGHT LINE METHOD. TAX-EXEMPT REVENUE BOND FINANCING WILL BE LIMITED TO BONDS THAT ARE PUBLICLY APPROVED AND AFTER 1985, RECEIVE A FINANCIAL COMMITMENT FROM THE LOCAL GOVERNMENT. SMALL ISSUE INDUSTRIAL DEVELOPMENT BONDS WILL NOT BE ALLOWED FOR LARGE BUSINESSES.

TAX REVISIONS
(CONTINUED)

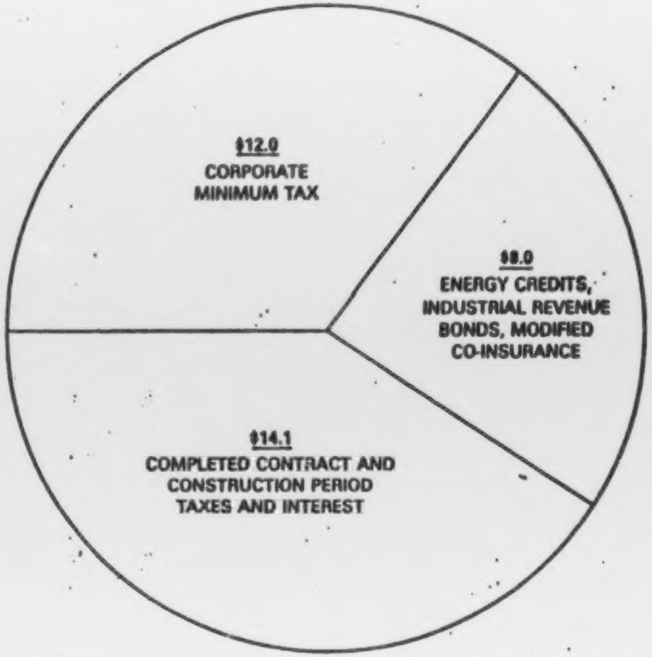
- REPEAL UNINTENDED WINDFALL FROM MODIFIED CO-INSURANCE TAX ACCOUNTING ROLES.
- AMORTIZE CONSTRUCTION PERIOD INTEREST AND TAXES INCURRED BY CORPORATIONS TO DEVELOP NON-RESIDENTIAL REAL PROPERTY. COSTS WILL BE RECOVERED OVER TEN YEARS.
- TO THE ADD-ON MINIMUM TAX WILL BE REPLACED WITH A 15% ALTERNATIVE MINIMUM TAX THAT WOULD APPLY ONLY TO THOSE CORPORATIONS THAT PAY VERY LOW REGULAR TAX RATES.

TAX REVISIONS

(BILLIONS OF DOLLARS)



FY '83: $7.2



FY '83 - '85: $34.1

VIEWS OF THE REAGAN ADMINISTRATION

WEDNESDAY, FEBRUARY 24, 1982

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met, pursuant to notice, at 10:17 a.m., in room 6202, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Grassley, Kasten, Hollings, Chiles, Biden, Metzenbaum, Riegle, and Exon.

Staff present: Stephen Bell, staff director; Gail Fosler, chief economist; Lizabeth Tankersley, minority staff director; and Kemble Stokes, chief economist for the minority.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Chairman DOMENICI. The committee will be in order.

Mr. Secretary, we are delighted to have you here before us today. A year ago you appeared before our committee to discuss the first full steps that you as a spokesman for the Reagan administration contemplated to reassert control over Federal spending and to reduce the burdensome taxes. At that time we suffered from tenacious inflation and lagging growth because of 20 years of stimulative fiscal and monetary policy. We had undermined public confidence to a point where Americans preferred to invest in real estate and Persian rugs rather than in their basic industries.

The time had clearly come to retrench, to move the economy onto more solid ground by reducing the intrusion of Government into the economy, both through its spending, which was unchecked, and through its inflation fuel taxation.

Now, a year later, it is apparent that the problems of our economy run deeper than any of us thought. We have seen in recent months an unprecedented rise in interest rates at the very depths of a severe recession. Major sectors of the economy are on the verge of bankruptcy for lack of consumer demand and for lack of credit at affordable interest rates. Unemployment is near 9 percent and threatens to rise higher before it recedes. Stock and bond markets are at historic lows, and they have reacted adversely to the 1983 budget, at least in the first few weeks since its presentation.

TIME FOR REEXAMINATION

All of these lead me to conclude that we have before us a time for reexamination and that is what this committee will have to do.

I am not questioning our goals but our means of achieving them and the probability of achieving them in the coming months. Now, as before, we cannot let up on our efforts to control Federal spending, to preserve as best we can the marginal tax rates and to free business from regulatory encroachments that are not needed. We must continue to support the Federal Reserve as it attempts to wean the country from its inflationary ways.

I hope that you can explain how we can further tighten our fiscal policy, reduce interest rates, and steer away from a head-on conflict with monetary policy.

I know, Mr. Secretary, that these are difficult questions. For me to say that it is your job is indeed imposing an extreme burden on you, but that is basically, as I see it, what we are interested in finding out from you.

I yield to my distinguished friend, the minority leader of this committee, Senator Hollings. Then we will proceed directly to you. After you have spoken, each member will have 5 minutes for either opening remarks or questions. Senator Hollings?

Senator HOLLINGS. Thank you, Mr. Chairman. My colleague, Senator Chiles, does have a statement, if you do not mind.

GIVE MORE SOBER COUNSEL TO THIS BUDGET

I would only make one observation, Mr. Secretary, and that is this: You deliver your testimony and defend the President's economic program. The one really disturbing factor is how, being an acknowledged business success and knowing the economy and Treasury work as you do, can you be constantly cheering on the President's program. You ought to be perhaps giving a little bit more sober counsel with respect to this particular budget. Here you have presented a budget that calls for a $100 billion deficit in 1983. You just signed a good budget in 1982. That is less than 2 months ago. But your 1983 budget calls for $100 billion in spending and you do not have; it is all in red ink. Yet, all your colleagues, including your former firm, Merrill Lynch, do not agree with your statistics at all. All the business leaders come up and tell us that it is wrong, wrong, wrong, wrong. Yet, when they go to the White House, you and all of them tell the President: right on, right on, don't retreat.

It is a sort of cheerleading, B movie session, one for the Gipper or something. I say that in all seriousness. It is disturbing to me. If I were in this kind of trouble, I would be getting you and the business leadership together and say: Look, somehow this thing has gone awry. You know it because in September, a month after it was signed into law, you went immediately and tried to change it by making an adjustment on September 24. So, I know you know it.

BUSINESS LEADERSHIP NOT LEVELING WITH PRESIDENT

You are telling the President right on, but you are voting with your pocketbooks, you and the whole business community, in the other direction; every one of you are. That is the most frustrating thing in the world. Here the President has got the liaison and communications with the finest of the business leadership that we have, and they are not leveling with him. Yet, they are with us.

They are with their pocketbooks and with their investments and everything, I wish you would think over that in your statement. Maybe later you can explain it to me because it is just not adding up. We are going through a tremendous charade here, and we have got to come to grips because we are going down the tube economically. We have got to do better than what we are doing. We have got to counsel with the President.

No one is trying to defeat Reaganomics. If it works, we are all rich. And then finally we can discuss programs. I am trying to maintain the supply side in my approach. So, there is nothing vindictive or politically partisan.

You and your business crowd constantly come running over to the Congress. We had a breakfast yesterday with all the budgeteers, five former Directors of the Office of Management and Budget—former Republican Directors shaking their heads no, no, no. But, when they go over to the President, they say yes, yes, yes. And you come cheering him along this morning.

Excuse me. I probably took too much time.

I am sincere about that thing. That thing is the worst thing we have got going on in this Government.

PRESIDENT AND CONGRESS NOT HEARING SAME THING FROM BUSINESS COMMUNITY

Chairman DOMENICI. Mr. Secretary, I cannot say it as eloquently as my friend, but I think the point that he is making—obviously I do not agree with the reference to you because that is your job, but I really believe the President ought to talk. Those who are out there in the business world ought to talk more frankly with the President. I cannot pass judgment on how he should react. But I do not think he is hearing the same thing from the business community as we are. I think that is basically what the Senator is saying.

So that everybody here will know and my friend will know, the reason we were 5 minutes late is because I had just had him in the office and told him the same thing. I asked him if he could arrange to have some people who visit with us visit with the President and tell him what they are telling us. Senator Chiles?

Senator CHILES. Mr. Chairman, you have made half of the opening remarks I had planned to make, so I will not repeat them all.

I do note in the Secretary's statement that he says that financial leaders are waiting to make these changes, to enact all the President's spending proposals to insure we are not going to change the program. Well, that is not what I was hearing at breakfast yesterday with the Giaimo committee that Senator Hollings has referred to. We had a number of Fortune 500 and Business Roundtable people there. They were saying "for goodness sake, you've got to do something about those deficits in the President's budget."

GET THE DEFICIT NUMBER DOWN

They said "cut defense, raise taxes, do what you have got to do, but get that deficit number down. It is just going to be essential that Congress does that."

I hope that they were not just telling us that because they need to send that message down to Wall Street. I think, since you are the leading spokesman in the administration who is dealing with the Nation's financial markets, you certainly need to be talking about reducing the deficit, too.

I hope you can tell this committee how we are going to have a strong economic recovery without providing some kind of assistance to the housing industry. As I look at your proposals in this budget, it looks like to me that you would kick the housing industry while it is down. Of course, failing to do a job on the deficit keeps the interest rates high to start with. But then it looks like to me that you propose to drastically cut every part of the budget that helps housing, including Ginny Mae, which provides access to the credit markets; but which does not cost a single dollar in outlays. Yet, you propose to reduce Ginny Mae activity level from $68 billion to $48 billion this year and knock it down another $10 billion in 1983. That would be a total reduction of $30 billion, or a 44-percent cut over 2 years.

FURTHER CHAOS IN HOUSING CREDIT

It seems like to me, given the straits that the thrift institutions are in—and since the administration has said they are not going to do anything to bail them out—then your proposal would cause further chaos in the housing credit.

I see where the cut is justified by saying that Ginny Mae borrowing is going to ease the pressure on credit markets and cause lower interest rates. But you also say that the private institutions are going to take over credit for housing. If the private institutions provide that credit, then the market feels just as much pressure. If the private institutions do not take over, then housing dips that much more. For the life of me, I do not see how you can have a sound economic recovery that way. Maybe I just look at it from my State's perspective because housing is a tremendous factor in Florida. But without the housing industry having some recovery, how can we have a sound economic recovery?

I look at Farmers Home. Under the administration's proposals, direct loans are cut 70 percent. Section 202 housing units for the elderly and handicapped would be cut 41 percent. In FHA, you cut a full $5 billion—from $40 billion to $35 billion. The "tandem financing" of GNMA for section 8 would be zeroed

It just seems incredible to me that you are talking about pulling back on construction commitments for section 8 housing that are already in the pipeline. This committee has worked for years to see that we pull back some of the excess in those commitments. But now to cut back on commitments in which builders have already bought their lots, purchased some of their materials and put their crews on will just add tremendously to the unemployment and the chaos that is already out there in the building industry. I certainly hope you will address this issue when you get a chance to make your statement.

Chairman DOMENICI. Thank you, Senator. Mr. Secretary, we will make your entire statement a part of the record, without objection. You may proceed as you desire.[1]

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[1] See p. 132.

STATEMENT OF HON. DONALD T. REGAN, SECRETARY OF THE TREASURY

Secretary REGAN. Mr. Chairman, since the administration's 1983 budget proposal is well known to all of you by now, I thought I would submit my prepared statement for the record and take this time to make some additional remarks.

LEGACY OF STAGFLATION, FAILED POLICIES, HIGH INTEREST RATES, AND INFLATION

I realize that this is a difficult time for the economy. No one relishes the thought of Americans out of work. However, in seeking a solution it is imperative that I point out that the short-run improvisations of past administrations to deal with economic crises have left a legacy of stagflation, failed policies, high interest rates, and inflation. The previous decade and one-half has seen a series of quick fixes to deal with short-run difficulties.

An income tax surcharge was applied at mid-1968. But after the passage of the surtax, fears of fiscal overkill floated to the surface, and the Federal Reserve lowered the discount rate and pumped up bank credit, only to reverse itself later in the year as inflationary pressures gained in strength.

The recession of 1968–70 ensued and was followed soon thereafter by the ill-fated Nixon price controls of 1971–74. The consequence was an uncertain economic condition.

In late 1974 the Ford administration was still fighting inflation with its WIN program while the recession of 1973 and 1975 was well underway. After the recession had largely run its course, fiscal policy was eased in early 1975 and monetary policy shifted to an easier stance, thus the Carter years of high taxes and monetary expansion with their legacy of severe inflationary pressures.

When this administration took office it inherited a very difficult economic and financial situation. The economy was stagnant and inflation pressures were strong. Real gross national product had fallen and the GNP deflator had risen by 9 percent. This only marked the culmination of a process in which real growth had fallen in every year of the Carter administration and the inflation rate had risen. The Government was locked into a policy of deficit spending, looking to the Federal Reserve for its monetization. The money supply increased at an annual average rate of 7.5 percent through the Carter years compared to an annual average rate of increase of some 5 percent over the previous 4-year period. By 1980 both real growth and inflation objectives had largely been abandoned in the face of economic stagflation.

In a very real sense, economic policy was on automatic pilot trying to deal with erratic short-term swings but with no clear sense of long-run direction.

Continued policy failures over a 10- to 15-year period finally led to the incredibly high interest rates and to the economic disruptions that we face today.

ADMINISTRATION RESOLVED TO CHART NEW COURSE

The Reagan administration resolved to chart a new course. Rather than to drive the economy with Government spending and money creation, our goal is to restore noninflationary economic growth which produces private-sector jobs and income. Unfortunately, the recession hit before all of our program could be put into place. The National Bureau of Economic Research dates the beginning of the recession in July of 1981. The economy has really gone nowhere after early 1979, with real growth stunted, inflation unchecked, and interest rates at very high levels.

The Reagan budget and tax program was signed into law in August and became effective October 1, 1981. Monetary policy was the only part of the Reagan program which did not require legislative action or unavoidable administrative delay. Working with us, the Federal Reserve did not monetize the Carter deficit that we inherited, and slower monetary growth brought down the rate of inflation dramatically.

The CPI has risen at a 5.3-percent annual rate in the last 3 months compared to 8.9 percent for all of 1981 and 12.4 percent in 1980. The Producers Price Index has also risen at about a 5.3-annual percent over the last 3 months, compared to 7.2 percent in all of 1981 and again 12.4 percent in 1980.

The GNP deflator has reacted more sluggishly, but there are signs of improvement there as well.

The current economic environment poses real policy challenges. In the past the policy response to a recession has typically taken the form of a series of quick fixes with little concern for their ultimate consequences. It is certainly possible to put together spending programs to help particularly distressed sectors. A variety of tax measures touted as temporary could be formulated as well. But none of these will work to overcome the fundamental economic problems which have produced the current recession and which will produce other recessions in the future if not corrected. Our program does deal with those problems.

FULL EFFECT OF PROGRAM WILL TAKE TIME

Our program deals with fundamentals, and it will require time to take full effect. The economic difficulties that our program seeks to overcome have required years to develop. There is no overnight solution. If we tinker with the basic thrust of the program, it will never get a chance to work and we will lapse back into that depressing cycle of low growth and high inflation that has brought us to where we are today.

The deficits which we are currently facing are certainly troublesome. Deficits do matter, and they do concern this administration. It is important to realize, however, that the major factor in these deficits is the revenue loss from real growth. The fallen receipts of $31 billion in 1982 compared to our 1981 forecast is entirely related to economic assumptions. Raising taxes to deal with the deficit would only make the recession worse. Rather than helping the economy and the budget, the higher marginal tax rates that would result from some quick fix like a surtax or repeal of the individual tax cuts would reduce work, savings and investment, lower real economic growth, and worsen the budget picture.

Look at what happened to the Johnson surtax. President Johnson imposed a surtax of 7.5 percent in 1968, 10 percent in 1969, and 2.5 percent in 1970. From late 1969 to late 1970, real GNP declined by 1 percent. Unemployment rose from 3.4 percent in 1969 to 6.1 percent in 1971. A $25 billion deficit in 1968 went to a 3.2 surplus in 1969. But by 1971 and 1972, the deficit had jumped back to $23 billion in each year.

For years we have attempted and failed to balance the budget with higher taxes. We have only succeeded in wrecking the economy. The only real way to balance the budget is through increased economic growth, and an increased growth would not be possible with higher marginal tax rates. Tying tax cuts mechanically to economic performance is equally self-defeating. Tax cuts are needed most when the economy is sick. To raise taxes when the economy is healthy would cause a return to lower growth. The last 15 years of endless experimentation with fine-tuning of tax and economic policy has clearly shown that the only result is slower growth, higher inflation, and higher interest rates.

POLICIES WILL WORK IF LEFT ALONE

The time has come to break that dismal sequence. The long-run policies that are now in place will work if they are only left alone. The recession, itself a legacy from the past, has thrown the budget numbers into heavy deficit. Without the recession, progress toward early budget balance would be clearly apparent. What we face are transitional budget deficits, large in absolute size but not in relation to typical recession experience such as 1974 and 1975.

This is a critical point for the determination of economic policy. We must not be thrown back into a series of stop-go measures. Our long-run course is clearly charted. We must have the good judgment and resolve to stick with the current policies. To do otherwise is to assure this committee that we will be back again this year and next year and every year following, still reacting, still looking for a quick fix to the problems caused by the previous quick fix.

Last year when I appeared before this committee, the challenge before us was inflation. The urgency for action then was no less than today. That threat has abated. But we must not solve this year's challenge with a policy that will result in next year's crisis. This type of patchwork-quilt economic policy must stop.

In conclusion, Mr. Chairman, I look forward to working with you and with members of this committee from both sides of the aisle. This administration achieved last year's success through the help and cooperation of those on the Hill; this year will be no different.

I welcome the input of new ideas and suggestions on how we can improve our budget proposals and achieve long-term economic stability. Thank you, Mr. Chairman.

Chairman Domenici. Thank you, Mr. Secretary.

PREPARED STATEMENT OF HON. DONALD T. REGAN, SECRETARY OF THE TREASURY

Good morning.

President Reagan's budget is a blueprint for growth and prosperity.

It is a plan for reducing Federal spending and the tax burden.

It is a plan for increasing the family budget.

For the first time, we are asking the right people to tighten their belts: the Federal government.

We have painstakingly gone through every item. All members of the Cabinet have met with the President on their programs. And we have fashioned a budget that responds to the President's call for a new Federalism; it meets the complex needs of our society; and it reduces the rate of growth in government.

This budget contains dramatic reductions in government spending, yet it's important for people to know that we are not tearing down the house or ransacking the furniture. We are simply trying to stop the runaway growth of past Federal spending and restore a measure of common sense to how we spend the people's money.

So let's take a quick look at how this budget was put together.

On the revenue side, we expect receipts totalling $666.1 billion for fiscal year 1983, of which $304.5 billion comes from individuals, $65.3 billion from corporations, $225.5 billion from payroll taxes and the remainder from excises, Federal Reserve earnings, and miscellaneous taxes and fees.

More importantly, we have in place a sound long-run tax system for the 1980's, one that will promote rapid growth of income, savings, investment and employment for years to come. That tax system, with a healthy economy, will generate as much revenue as government should reasonably be allowed to spend.

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However, the revenue picture has been heavily affected by two factors: the recession and the drop in inflation -- one bitter pill and one piece of candy which together have signficantly decreased revenue to the point of causing large deficits. The recession is temporary, and the decline in inflation is most welcome.

We, therefore, had to face some tough decisions about how to cover the costs of some very important government programs -- how to make up the difference between the $666.1 billion in revenues and the $757.6 billion in outlays -- until the growing economy triggered by our reformed tax system brings growing revenues into line with restrained outlays.

Some have urged us to revoke the incentive-creating tax cuts already in place. The result would have been lower real growth for many years into the future. It would have involved a self-defeating major change in a permanent tax program to handle a temporary problem. That alternative was not seriously considered. Instead, we shall propose certain worthwhile tax reforms, upgrade our tax collection program, renew our efforts at controlling spending, and borrow to cover the remaining deficit.

Deficits are not good. They rob the private sector of financial and real resources needed for growth, and divert those resources into government consumption. So do taxes. The root of the problem is the Federal spending which appropriates those real resources and then must find the means to pay for them in one way or another.

The budget deficit can and must be narrowed from the spending side. For too long, spending has been rising faster than the economy has grown. The economy can no longer support the burden. Some progress was made last year in reducing the runaway rate of growth in Federal non-defense spending. Further efforts will be required this year and into the future.

Insofar as spending is not reduced, it is preferable to close the remaining transitional recession deficits of the sort now being experienced by borrowing rather than by taxing. The funds are pulled from the private sector in either case, but taxes impose a larger cost in terms of reduced incentives for real growth.

We must continue to strive to reduce the deficit by curtailing spending and promoting real growth. The budget and outlook we are proposing take major steps toward closing that deficit over the next several years. In the interim, it can be handled in a nondisruptive fashion. Let me put the deficit into perspective.

The projected deficits, though some of them are at record dollar levels, are not unusual following a recession when measured as a percent of GNP. The first attached chart shows deficits as a percent of GNP since 1975.

On- and off-budget deficits were 3.6 and 4.5 percent of GNP in Fiscal Years 1975 and 1976, due largely to the 1974-1975 recession. Deficits are projected to be 3.8 percent and 3.1 percent of GNP in Fiscal Years 1982 and 1983, largely as a result of the current recession. There has been considerable concern that our projected deficits will put extreme pressure on credit markets and thus drive up interest rates. However, deficits do not cause high interest rates. The historical record shows no direct association of deficits and interest rates; the second chart shows that in years with large deficits, interest rates went down more than they went up. Interest rates are determined by the real rate of return on capital, the expected inflation rate, and a premium for risk. Although deficits could conceivably influence expected inflation and risk, this would not happen, according to the latest Federal Reserve Board report, unless they were accompanied by excessive money creation.

As you all know, this administration has adopted a policy of slow and steady growth in the money supply. We are in agreement with the Federal Reserve Board's fight against inflation and support their announced intentions to reduce money growth rates gradually from year to year. Although we are concerned about the affect of the volatility in money growth on interest rates, we intend to work closely with the Fed in order to reduce these unhealthy fluctuations.

The deficits will be manageable because of the growth of private sector saving, as shown in the third chart.

Private saving resulting from normal year-over-year growth and the Economic Recovery Tax Act will be several times greater than the total borrowing requirement of the Federal government in 1983 and 1984 and thereafter.

The net additions to total private saving are larger than the rise in the deficit. They will produce "crowding in" rather than "crowding out." This extra shot in the arm of capital markets will put downward pressure on interest rates. Even after financing the Federal deficit, there will be billions of additional dollars each year for private investment.

Normal year-to-year increases in saving exceed $40 billion each year. This will be supplemented by the additional personal savings and additional business retained earning induced by the tax cuts.

Compared to 1981, private saving will be more than $60 billion higher in 1982, more than $170 billion higher in 1983, and more than $260 billion higher in 1984. Private saving was just under $480 billion in 1981. It will rise to more than $740 billion in 1984.

It has been lack of growth, more than anything else, that has been responsible for the current and projected deficit. As a rough rule of thumb, each time growth falls off by enough to produce a 1 percent increase in unemployment, the budget deficit widens by more than $25 billion. In fact, if we had grown fast enough over the past four years to get unemployment down below 6 percent, the current deficit would be roughly $75 billion lower.

Growth is the only way to balance the budget while promoting rising real income and employment. If the economy were growing at 4 to 5 percent per year in real terms, Federal revenues would be rising $30 to $35 billion per year in real terms, even under an indexed tax code without the windfall to the Federal government from bracket creep. That is how fast the deficit would be falling in 1982 dollars if real spending were being held constant. We have not asked for spending restraint of that magnitude, choosing a more gradual path toward budget balance. After a slight dip in real outlays in FY 1983, real outlays are projected to grow approximately one-third as fast as the economy in the following four years. However, we would be willing to look at further spending restraint if Congress wishes.

I would like to point out, very firmly, that any changes in the economic recovery program which reduce real growth will tend to worsen the budget picture. Changes which reduce individual or business saving by as much as or more than the deficit will only worsen the situation in the credit markets.

The budget is not merely an accounting document. One cannot simply take a billion dollars cut of column A and put it in column B. There are behavior changes and economic repercussions from tax and spending shifts which affect saving, investment, labor supply, income and revenue. Very often, changes which may look good on paper will buy little or no progress toward solving a budget problem, especially compared to the economic cost to the whole nation of the policy shift.

These facts should be kept clearly in mind as we look at the deficits in this budget.

As President Reagan points out in his Budget Message, our success in reducing inflation has reduced tax receipts. Over the next five years, we project a steady fall in inflation. Yet if nominal GNP growth were just 2 percent higher each year, reflecting a continuation of higher inflation, Federal receipts would be enlarged by $353 billion over the five years as inflation and the progressive tax code pushed taxpayers into higher brackets. After allowing for inflated outlays, the budget deficit would be $38.5 billion lower in 1987.

In the past, this is how Administrations and Congresses planned to balance the budget. We have a better plan. We intend to balance the budget through spending restraint, lower taxes and higher real growth, not through inflation. In the short run, there will be substantial deficits, due primarily to the recession. However, we are confident that personal and business savings over the next few years will be adequate to finance both the projected deficits of the total government sector and a very rapid increase in real capital formation.

I realize that there has been concern over the apparent reluctance of business to plunge ahead with new investment. It is not suprising that some businessmen are holding back until they are certain it is safe to proceed. A lot of them are waiting for lower interest rates. Others are waiting to make certain that Congress will not make drastic changes in the Economic Recovery Tax Act so that they can plan with confidence. Nothing kills investment faster than uncertainty. Once these problems are resolved, the investment will be there.

RECEIPT PROPOSALS

While the Administration is opposed to increasing statutory tax rates -- rates which apply at the margin to taxpayers who work, save, and invest -- at the same time it is committed to insuring that the tax system is run efficiently and fairly. Thus, while we will not support increases in marginal rates for taxpayers, we do propose changes in three areas: 1) an elimination of abuses and obselete incentives within the system; 2) a major effort to improve tax collection and enforcement and 3) enterprise zone tax incentives and miscellaneous efforts to charge users of various Federal programs for the benefits they receive.

We want to eliminate abuses and to remove obsolete incentives within the system. In many cases, abuses arise because the use of special types of financial arrangements or legal devices allow one taxpayer to pay a much lower tax than a similar taxpayer engaged in exactly the same activity. Through the Accelerated Cost Recovery System (ACRS) and other provisions included in the Economic Recovery Tax Act of 1981, Congress, working with this Administration, has lowered effective marginal tax rate on all types of business activity. We do not, however, support haphazard and arbitrary reductions in average tax rates for specific groups of taxpayers.

Eliminating tax abuses is entirely consistent with the Admnistration's overall economic program. The abuses that we propose to eliminate generally do not provide desirable incentives. Even when they might affect marginal tax rates, the effect is so distorted and so difficult to disentangle from other effects that hardly any desirable incentive is provided. Indeed, when a tax provision provides benefits only to a business or individual with special financial and legal arrangements, rather than to all taxpayers engaging in a similar activity, then it may end up subsidizing less efficient taxpayers with competent counsel over more efficient ones who rely on less competent legal and financial advice.

This Administration proposes also that Congress join with it in improving tax collection and enforcement. Ensuring that taxes due the government are, in fact, paid by taxpayers and that they are paid on a timely basis is necessary to the maintenance of a fair and workable tax system. If nonpayment of taxes is allowed to go unchecked, it can slowly eat away at the well-being of our system that relies upon voluntary compliance. If individuals instead are convinced of the certainty yet fairness of enforcement efforts, and they know that no taxpayer will be given preference in paying tax as income is earned, then the system can work well. Taxpayers will comply honestly and support a system which they think is fairly administered. However, if the Government fails to make adequate efforts at enforcement and adopt proper methods of administration, then that support will erode.

Strengthened enforcement and improved tax collection are entirely consistent with the Administration's economic program. Improved compliance and timely payment of taxes owed does not raise statutory tax rates and has almost no effect on the rate of return from saving and investment, but it does reduce the opportunities and benefits from underreporting income.

Those who underpay their taxes indirectly raise the tax rates of those who report all of their income and pay their taxes on a timely basis. It would be foolish to argue that efficient productive incentives are provided by our maintaining a system in which it is easier for some persons to underreport income or to pay taxes later than others must.

While this Administration is committed to a program of improved tax collection and enforcement, we are not wedded only to the proposals presented in the budget. We look forward to Congressional input into this program and believe that your suggestions for improving collection and enforcement efforts will be vital to developing an overall bill. I feel confident that the resulting bill will be fair to the American people, yet at the same time will address in a forthright manner problems of compliance, administration and timely payment of taxes.

Finally, the Administration has proposed a number of initiatives to improve upon incentives in the economy, to insure that direct beneficiaries and users of various Governmental services are required to pay for some of these services, and to make more rational and consistent the operation of existing programs. While the initiatives involve many issues besides tax policy, I want to discuss them briefly with you today because they also have an effect on receipts.

Shortly we will be releasing comprehensive explanations of our proposals for major tax revisions and for improvements in tax collection and enforcement. We are also preparing legislative drafts which we will send up as soon as they are completed. However, let me now provide you with some brief details on each of our proposals.

TAX REVISIONS

Completed Contract Method of Accounting

Current regulations allow contractors to defer tax on income from long-term contracts until the year that the contract is completed. This completed contract method of tax accounting permits full deferral of income reporting on progress payments received by the contractor throughout the term of the contract even though certain costs are currently deducted.

The completed contract method thus permits income to be deferred for tax purposes long after payments are received and long after income is deemed earned according to standard accounting practices. The use of the completed contract method has led to large and unintended tax benefits. For instance, many contractors, including virtually all in the defense and aerospace industries, can substantially reduce their tax liability through the use of the completed contract method. This is accomplished by deferring all income from a contract until the contract is completed while taking allowable deductions for indirect costs currently. In some cases the period of deferral can be as long as 10, 15 or even 20 years.

Because of inflation and the increasing size of new contracts, deductible costs on new contracts often exceed income to be recognized from old contracts in any one year. The result has been that many taxpayers, while enjoying substantial economic profits and reporting these profits to shareholders and creditors, have been reporting large losses for tax purposes. These tax losses may shelter other income from taxation. In at least one case, the losses have been sufficient to eliminate the taxpayer's accumulated earnings and profits, enabling that taxpayer to make tax-free distributions to shareholders.

A particular problem resulting from the long-term contract accounting rules arises because certain construction contracts and contracts for the sale of heavy equipment include provisions for engineering or other assembly services to take place after delivery of parts and materials. Many taxpayers obtain additional deferral by maintaining that contracts are not complete until such services have been rendered. This is done even when full payment has been received upon delivery of parts and materials.

The Administration proposes legislation to disallow the use of the completed contract method of tax accounting, effective January 1, 1983. Taxpayers will be required to use either the percentage of completion method or the progress payment method of accounting for long-term contracts. The percentage of completion method permits current deductions for allowable costs but requires reporting income according to the percentage of the contract completed in the tax year. The progress payment method allocates costs to long-term contracts and defers their deduction until the taxpayer has a right to receive payment under the contract.

At the time the right to payment accrues, the taxpayer may deduct the total of the current and previously unclaimed costs allocated to a contract, up to the amount of the accrued payment. If the accrued payments exceed costs, the taxpayer would recognize such excess as income.

In addition, the Administration intends to amend the current completed contract regulations to require that most indirect costs (so-called period costs) be allocated to contracts rather than immediately expensed, and to clarify current rules regarding when contracts may be aggregated and when they must be severed in order to properly measure income.

The legislative and regulatory proposals would be effective for taxable years beginning after December 31, 1982. However, the legislative proposal provides that taxpayers may continue to use existing completed contract rules for contracts entered into on or before September 25, 1981, the date the Administration first announced its intention to change these rules. The regulatory proposal will similarly grandfather contracts entered into on or before September 25, 1981. Grandfathered contracts, however, may be affected by our corporate minimum tax as discussed below.

Repeal Business Energy Tax Credits

Under current law, businesses are allowed investment tax credits for energy property in addition to the regular investment tax credit. Also available are production tax credits and Industrial Development bond financing for certain energy sources. Current law further provides an excise tax exemption, or an equivalent tax credit, for gasohol. Some of these energy tax incentives expire at the end of 1982, but others extend through 1985 and beyond.

The original reasons for providing these tax incentives no longer apply today. At the time these incentives were proposed and enacted, price controls and allocations were in effect on both crude oil and natural gas, and there was substantial political resistance to decontrol. Prices of both oil and natural gas faced by consumers and received by producers were substantially below replacement costs, as reflected by the price of imported oil. Oil imports were growing at the same time that domestic consumption was being subsidized and domestic production discouraged.

Because of price controls, business firms and households had insufficient incentive to invest in energy-conserving capital or in alternative energy sources (other than oil or gas), or to use alternative fuels, such as fuels derived from alcohol, wood, or biomass. Therefore, some economic rationale may have existed for tax incentives for conservation and renewable energy.

Since enactment of the credits, however, crude oil prices have been decontrolled and partial decontrol of natural gas prices is being phased in. Whatever their original justification, the credits are no longer needed because most firms confront the true replacement cost of energy and therefore have sufficient incentive to invest in energy conservation and renewable energy and to purchase alternative fuels without targeted tax incentives.

The energy tax incentives distort the allocation of resources by encouraging firms to undertake investments that are uneconomic at current market prices and to purchase higher cost fuels when a lower cost substitute is available. As a result, these incentives divert workers, capital, and initiative from more productive uses elsewhere in the economy and lower the net productivity of the capital stock.

In general, tax incentives for specific investments fail to rely on markets to allocate resources efficiently. We believe that it is better to rely on the market, rather than Federal management, to determine patterns of energy use. The Administration's Accelerated Cost Recovery System (ACRS), enacted as part of the Economic Recovery Tax Act, has removed tax impediments to business investment -- including investments now eligible for energy tax incentives -- without dictating firms' choices among investment alternatives.

Moreover, by reducing the cost of only some conservation measures, the energy tax incentives discourage other, potentially more efficient, approaches. Many new inventions and refinements in old technology are not covered by the subsidies, and therefore are at a disadvantage because the Federal government subsidizes the competition.

Effective January 1, 1983, the Administration proposes to repeal all business energy tax credits, the gasahol excise tax exemption, and special provisions allowing States and localities to issue tax-exempt industrial development bonds to finance low-head hydroelectric facilities and other energy property. Fuel production credits and incentives for alcohol fuel production will also be repealed. Transition rules will mitigate the effect of repeal on taxpayers who have relied on existing law.

Restrict Tax-exempt Bonds for Private Activities

Current law permits States and localities to issue tax-exempt revenue bonds for industrial development, housing, and other private activities. There is no requirement under current law that industrial development bonds (IDBs) serve a genuine public purpose. In addition, tax-exempt financing, combined with Accelerated Cost Recovery and the investment tax credit, can result in unwarranted tax benefits.

The volume of private purpose tax-exempt bonds has grown rapidly. More than $25 billion were issued in 1981, up from $8.5 billion five years earlier. Private purpose bonds accounted for 24 percent of the tax-exempt bond market in 1976 but rose to 48 percent in 1981. The largest growth has occurred in small-issue IDBs, which allow tax-exempt financing for any trade or business. Small-issue IDBs marketed in 1981 reached an estimated $10.5 billion, out of the total $25 billion of private purpose bonds. Continued growth in the use of tax-exempt bonds for private purposes is expected unless actions are taken to limit their use. The expansion of tax-exempt bonds for private purposes affects the market for tax-exempt securities as a whole. This raises the cost to State and local governments of financing traditional public services.

Many of the private activities using tax-exempt financing would not have received direct Federal or local government assistance. Small-issue IDBs have been used to finance such private activities as office buildings for doctors and lawyers, fast food franchises, recreational facilities, and nursing homes operated for profit. Access to tax-exempt financing is offered in almost all political jurisdictions, either by State or local governments or by authorities acting on their behalf. These authorities are often established for the sole purpose of issuing tax-exempt revenue bonds for private entities and may serve to avoid local voter approval requirements.

Providing tax exemption for the interest on certain private purpose obligations may serve legitimate public purposes in some instances. Current law, however, does not require the showing of any genuine local public purpose. In fact, several issuing authorities have authorized tax-exempt bonds for facilities located outside of their own jurisdiction. A requirement that private purpose tax-exempt obligations be shown to serve the needs of the local community will improve the uses of the Federal tax benefit and will limit the volume of such obligations. This will reduce their impact on the market for traditional municipal bonds and the Federal government's revenue loss.

The availability of tax-exempt financing for exempt activities and other private purposes causes distortions in the allocation of capital resources. The ability to obtain a lower cost of borrowing for certain activities creates a bias in favor of investment in those activities. In effect, those favored activities are subsidized at the expense of other activities. Thus, the allocation of capital is based upon government decisions rather than upon its relative economic productivity.

Moreover, in combination with the accelerated cost recovery provided investment by the Economic Recovery Tax Act, tax-exempt financing results in unwarranted subsidy for many eligible borrowers. This combination of tax benefits completely eliminates the tax on income from certain investments and also provides tax shelter for income from other assets. "Double dipping" of this sort should not be allowed.

In contrast with other categories of private purpose tax-exempt bonds, exempt small issues may be used in limited dollar amounts for any type of investment in depreciable property or land. Large businesses presently are able to finance an unlimited number of facilities with small-issue IDB's because the dollar limits apply only within a single city or county. For example, one of the largest chains of retail stores in the country, has financed facilities in at least 100 localities, to the tune of $240 million since 1976. Many large firms are using small-issue IDB's even though they are able to raise funds readily in capital markets without a government subsidy or guarantee.

The Administration proposes that assets financed with tax-exempt bonds issued after 1982 must be depreciated using the straight-line method over extended recovery periods. In addition, the tax exemption for private purpose bonds will be limited to those that are publicly approved by State or local governments and which, for bonds issued after 1985, receive a financial contribution or commitment from the local government. Small issue industrial development bonds will not be allowed for large businesses, which have capital expenditures exceeding $20 million over a six-year period. Additional requirements relating to information reporting of IDBs, registration, and arbitrage profits also will be imposed.

Modified Coinsurance

Many insurance companies have entered into modified coinsurance arrangements and have claimed substantial reductions in their tax liability. Such arrangements are designed principally for tax avoidance since little, if any, insurance risk is actually transferred between companies.

In form, modified coinsurance agreements involve the transfer of insurance risk between two companies. In substance, virtually no insurance risk is actually transferred. Although together they may be in the same financial and risk position after the transfer, their combined taxes are lowered substantially. Many policies reinsured under modified coinsurance involve little, if any, present insurance risk. Because there is no meaningful transfer of risk, there is generally no significant non-tax business purposes for most modified coinsurance agreements.

Modified coinsurance agrements are structured so that actual payment between the companies is a small percentage of the amount of income converted. This small charge represents the "coinsurer's" fee for entering into the agreement. The nominal amount charged indicates the absence of any significant transfer of risk or economic purpose under the modified coinsurance agreement.

The modified coinsurance provision of the Code was never intended to produce large tax benefits for insurance companies. The federal corporate income paid by the largest mutual life insurance companies fell by 35 percent from 1979 to 1980, and by more than 40 percent from 1980 to 1981. The primary reason for this reduction is modified coinsurance. In several cases, the effect was to nearly eliminate tax liability.

Through regulations and legislation the Administration proposes to eliminate the unintended tax benefits resulting from the use of modified coinsurance. In addition, the tax treatment of other forms of coinsurance will be changed to prevent insurance companies from obtaining similar unintended tax benefits. The legislative proposal applies to all reinsurance agreements entered into after December 31, 1981.

Capitalization of Construction Period Interest and Taxes

Individual taxpayers must capitalize interest and taxes incurred during the construction of commercial and industrial buildings and deduct those costs over ten years. Under provisions of the Tax Reform Act of 1976, the write-off period for rental housing (other than low-income housing) is 8 years, but is scheduled to become 10 years by 1984. However, for corporations (other than subchapter S corporations and personal holding companies), the law permits immediate write-off of these costs. The substantial acceleration of cost recovery provided by the Economic Recovery Tax Act of 1981 makes it unnecessary to grant corporations an immediate deduction for a portion of construction costs.

It is a well-established financial and tax accounting principle that the costs of acquiring an asset, whether it is held for resale or for use in the production of goods and services for future sale, should be considered a capital cost, not a current cost, of earning income. Only when the asset itself is sold may the capitalized cost be recovered as a deduction from the sales proceeds in determining gain; or, if the asset is used by the owner to produce goods and services for sale, the capitalized cost may be recovered as deductions over a reasonable period as the asset is used.

Unlike most corporate taxpayers, individuals and partnerships are required to capitalize construction period interest and taxes other than those associated with low-income housing. These costs of acquiring assets are like other construction costs such as labor, materials, fees, and permits, all of which are capitalized and recovered when the real estate is sold or used to produce income. There is no economic policy or tax administration reason why corporations should not be subject to the same rules as individual taxpayers who construct commercial and other nonresidential buildings. Indeed, it is both economically inefficient and unfair to apply different sets of accounting rules to taxpayers according to their form of organization.

The Administration proposes that construction period interest and taxes incurred by corporations to develop non-residential real property after December 31, 1982 be capitalized. Costs will be recovered over 10 years. This proposal will not change the tax treatment of residential construction. The cost of commercial construction undertaken by corporations will be increased by a small amount, normally less than 2 percent.

Corporate Minimum Tax

Corporations currently must pay a minimum tax, in addition to regular income tax, equal to 15 percent of certain tax preferences. This "add-on" minimum tax is not limited to those corporations that pay very little or no regular income tax. It may apply to any corporation that has reduced its tax liability through the use of designated tax preferences.

Nonetheless, many corporations currently pay no Federal corporation income tax, despite reporting large profits to their shareholders. The proposed corporate minimum tax would tax "corporate profits," that is, regular taxable income plus certain special deductions, and would apply only to those corporations that pay very low regular rates of tax.

For corporations other than Subchapter S corporations and personal holding companies, the Administration proposes to repeal the add-on minimum tax, effective January 1, 1983, and to replace it with an alternative minimum tax. Corporations will be required to pay the greater of their regular income tax or an alternative tax equal to 15 percent of their alternative tax base. This alternative tax base equals regular taxable income plus certain tax preferences, less $50,000. The alternative tax base will include both preferences from the current minimum tax and a number of new preference items. Current preference items also in the alternative base are:

- Percentage depletion in excess of the year-end adjusted basis of the property,
- Accelerated depreciation on real property in excess of that allowable under the 15-year straight-line method,
- Amortization of certified pollution control facilities, and child care in excess of normally allowable depreciation, and
- Reserves for losses on bad debts of financial institutions in excess of reserves allowable on the basis of their experience.

The alternative base will also include the following new preference items:

- Intangible drilling costs in excess of amounts allowable had they been amortized over 10 years,
- Mining exploration and development costs in excess of those allowable under a 10-year amortization schedule,

- Lessor's leasing benefits which are in excess of net cash investment amortized on the straight-line basis over the term of a safe-harbor lease,
- Deductions for interest on debt to carry tax-exempt securities,
- Deferred DISC income,
- Shipping income deposited in capital construction funds or construction reserve funds,
- Amortization of motor carrier operating rights deductible under Section 266 of the Economic Recovery Tax Act of 1981,
- Original issue discount interest deductions in excess of amounts that would be deductible under a constant interest rate bond, and
- Current deductions of certain indirect costs incurred with respect to long-term contracts entered into before September 25, 1981.

The foreign tax credit is the only existing credit claimable against the alternative minimum tax. Investment tax credits which give no benefit due to the minimum tax can be carried forward.

We look forward to working with this Committee to develop a base for the corporate minimum tax that is reasonable and fair, yet insures that all profitable corporations pay their share of tax.

IMPROVED TAX COLLECTION AND ENFORCEMENT

Withholding on Interest and Dividends

Individuals who honestly report their interest and dividends pay more than their fair share of the total tax burden. Recovering known lost tax revenues by withholding -- where a reporting system is already largely in place -- is both an efficient and a sensible step to take.

Imposition of withholding on interest and dividends is a natural complement to the Economic Recovery Tax Act objective of reducing the tax burden on income from investment. Withholding offers an opportunity to increase tax revenues substantially without raising taxes on those citizens who carry their full share of the tax burden of this country.

While individuals are estimated to underreport wage income by only 2 to 3 percent, the comparable figure for interest and dividend income is 9 to 16 percent. Even with the additional reporting requirements enacted in the Revenue Act of 1962, a number of taxpayers still fail to report and pay tax on around $20 billion of taxable dividends and interest.

As interest and dividends have increased as a share of individual incomes, the compliance problems of underreporting has also increased. In 1962, interest and dividends represented approximately 5.3 percent of adjusted gross income; by 1981, interest and dividends represented 8.4 percent of reported adjusted gross income -- an increase from $40 billion to $150 billion. At the same time, the portion of individuals' income represented by wages declined by at least an equivalent amount. As a result of this change in the composition of the Nation's income, taxpayer compliance overall has declined because a smaller portion of overall income is subject to withholding.

Unfortunately, information reporting is simply inadequate to reduce this shortfall. Much of the unreported interest and dividend income consists of relatively small amounts that millions of taxpayers simply neglect to report -- as a result of failure to maintain records, or other causes not amounting to fraud. Although the IRS matches a high proportion of the information returns filed, there are a number of reasons why the matching process cannot close the gap of unreported income. Many information returns contain inadequate or inaccurate information, with the result that matching is difficult or impossible. In the wage area, by contrast, the number of unprocessable information returns is much lower because taxpayers have an incentive to obtain proper credit for withheld taxes. It is extremely expensive for the IRS to use letters, phone calls, and personal visits to follow up taxpayers suspected of underreporting, especially when only small amounts of tax may be collected from each one.

The obvious failure of some taxpayers to report interest and dividend income diminishes public respect for the tax system, and jeopardizes our system of voluntary compliance. Moreover, past experience has proven that withholding is by far the most effective means of combatting noncompliance in the reporting of income.

Under the proposal, 5 percent of payments of taxable interest and dividends would be withheld. Nontaxable individuals filing exemption certificates and corporations would be exempt from withholding. Taxpayers aged 65 or older with a tax liability of $500 ($1,000 on a joint return) or less would also be exempt from withholding. This will exempt elderly couples earning less than $14,907 in 1983.

This withholding proposal differs significantly from past withholding proposals. The problem of forced overwithholding, so prevalent in those past proposals, has been virtually eliminated by the low rate of withholding, the proposed exemption procedures, and the provision in ERTA which will allow workers to adjust wage withholding for any overwithholding that could occur. In addition, we must recognize that the system of reporting of interest and dividend income on forms 1099 is well established; new forms will be quite similar to the old forms, with an additional line for the amount of tax withheld. Costs to financial institutions thereby will be kept to a minimum. Indeed, my own experience as head of a large financial organization, along with many discussions with officers of our Nation's financial institutions, has convinced me that withholding is a sound and efficient means of increasing compliance.

Corporate Income Tax Payment Speedup

Corporations generally are required to pay at least 80 percent of their current year's tax liability in estimated payments due four times a year. The remaining liability is payable in two equal installments due on the 15th day of the 3rd and 6th months following the close of their taxable year. An exception to the estimated tax payments rules permits corporations to base their estimated tax payments on the full amount of their prior year's tax liability. For large corporations, the estimated payments must be at least 65 percent of their current year's liability (75 percent in 1983 and 80 percent thereafter).

To the extent feasible, taxes should be paid on a current basis. Given the ability of corporations to estimate their income on a monthly basis, there is no longer any reason to permit corporations to underpay their taxes by up to 20 percent. A 10 percent deviation is sufficient to reflect the uncertainties of intra-year estimates.

In order to collect corporate taxes on a more current basis, the Administration proposes, for tax years beginning after 1982, to increase the required estimated tax payment from 80 percent to 90 percent of the current year's liability, and to require that all remaining liability be paid in one payment on the 15th day of the 3rd month following the close of the tax year. In addition, large corporations making estimated tax payments based on prior year's liability will be required to pay at least 85 percent of their current year's liability in 1985 and 90 percent thereafter. All corporations with taxable incomes of less than $1 million in each of the three prior years will be exempt from this latter rule.

IRS Staff Increases

In order to improve the efficiency of enforcement and collection activities, the Administration proposes to increase the enforcement staff of the Internal Revenue Service by more than 5,000 persons.

Three thousand of these 5,000 new employees will be assigned to collecting delinquent taxes, 1,000 will concentrate on the identification of nonfilers who owe tax, and the remaining 1,000 will examine deficient returns and process appeals.

Although the vast majority of taxpayers voluntarily pay their correct tax on time, delinquent taxpayers currently owe the Treasury more than $20 billion in uncollected taxes. An estimated additional $70 billion in revenues are lost each year as a result of unreported income and improper deductions. A strengthening of Internal Revenue Service enforcement activities will generate increased government revenue and will improve the fairness of the tax system for all taxpayers. Public confidence in the equity of our tax laws is preserved only if the few who fail to pay their fair share are held accountable.

OTHER PROPOSALS AFFECTING RECEIPTS

Enterprise Zone Tax Incentives

Under current law, no special tax incentives are provided for the redevelopment of depressed areas. The Administration therefore proposes that beginning January 1, 1984, up to 25 small urban areas per year (not to exceed 75 in total) may be designated as "enterprise zones". Relief from Federal, State or local regulations, and special tax incentives designed to increase investment and employment will be provided businesses and individuals locating in these areas. These incentives will be applicable for a 20-year period. The Administration will be providing you with details on this proposal at a later date.

Miscellaneous Proposals

- Airport and airway trust fund taxes. Statutory authority for the airport and airway trust fund expired on September 30, 1980. The Administration proposes to reinstate statutory authority for the airport and airway trust fund effective July 1, 1982.

- Increases in passport and visa fees. The Administration has proposed an increase in passport fees from $15 to $30 effective April 1, 1982, and an increase in immigrant visa fees from $25 to $100 effective March 1, 1982.

- Change in railroad retirement system. The railroad retirement system provides coverage generally equivalent to a combination of social security and a multi-employer industry pension plan. Railroad employees and employers make contributions to railroad retirement that are generally equivalent to social security payroll taxes. Beginning October 1, 1982, the Administration proposes to extend full social security coverage to railroad workers; payroll taxes would be deposited directly in the social security trust funds. The Administration also proposes to return the rail industry's plan to the private sector.

- Extension of highway trust fund taxes. Under current law, the 4 cents per gallon tax on gasoline and diesel fuels will decline to 1.5 cents per gallon on October 1, 1984. Several other taxes that are deposited in the highway trust fund will be reduced or will expire at the same time. The Administration proposes to extend these taxes at their present rate.

- Extension of social security hospital insurance taxes to Federal employees. Most Federal civilian employees currently are exempt from social security taxes. The Administration proposes to require Federal employees to pay the employee portion of the social security hospital insurance tax effective January 1, 1983.

Technical Proposals

As soon as possible technical proposals will be submitted to further close tax loopholes and facilitate IRS collection and enforcement efforts.

CONCLUSION

We have in place a tax system for the 1980's that will promote the growth of income, savings, investment and employment for years to come. Eliminating the incentives just adopted by Congress and choosing instead to steadily increase tax rates would only be a return to the policies of the past -- policies that have been tried and failed.

The budget deficits can and must be narrowed, but from the spending side, not the tax side. While the recession will cause substantial deficits in the short run, it is only higher real growth in the long run that will restore our

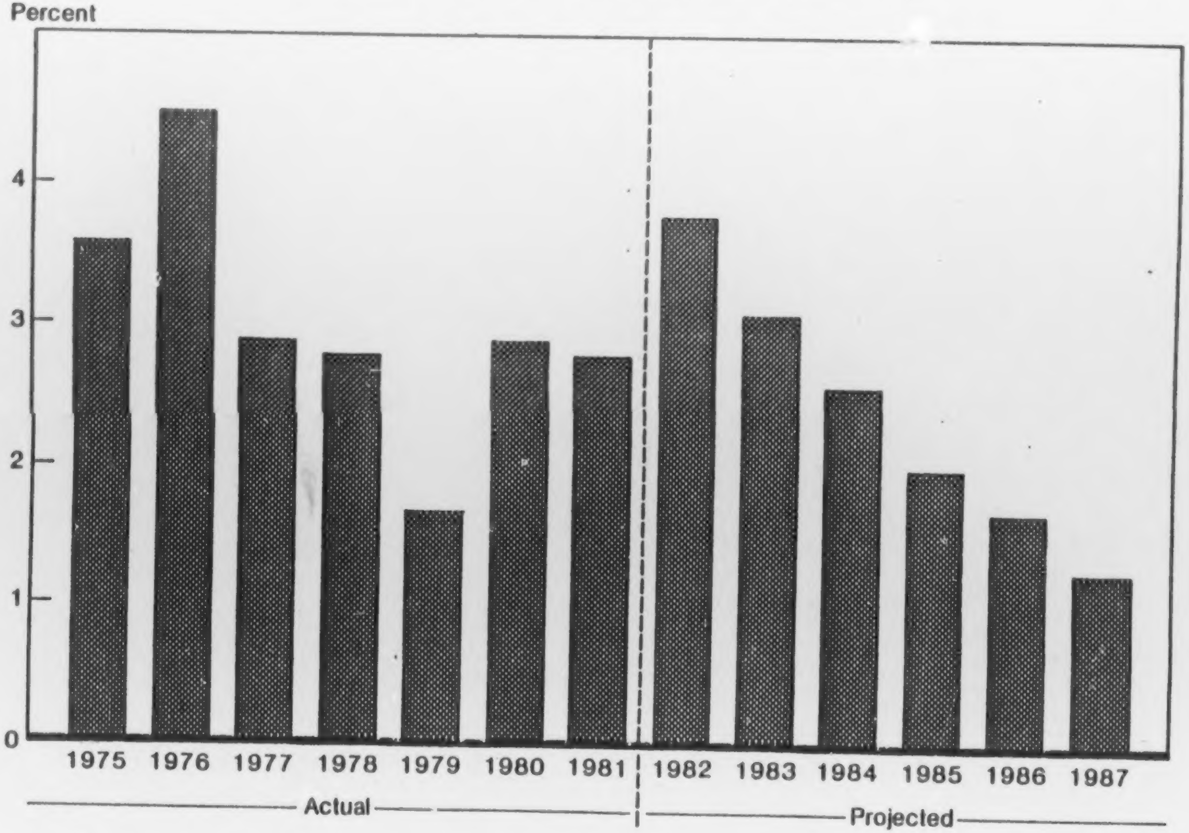
Nation's health. Raising tax rates will only exacerbate our problems by lowering possible future growth.

While the Administration is opposed to raising tax rates in general, it recognizes the need to insure that the tax system is run efficiently and fairly. We support a program to eliminate abuses and eliminate obsolete incentives, to make major improvements in tax collection and enforcement, to create enterprise zone tax incentives and to make efforts to charge users of various Federal programs for the benefits that they receive.

Let me throw out a final challenge to those who might oppose the Administration's tax program. I recognize that there are those who did not and do not support reductions in rates of tax for individuals and businesses, and I recognize that there are those who will oppose the initiatives that we have presented to you today. What I find most incomprehensible, however, are those persons who can oppose both. At least in part, these individuals can only be proposing that an increase in tax rates on all taxpayers is a better means of raising revenues than eliminating abuses and obsolete incentives, or improving compliance and enforcement programs. This type of choice, however, favors "special interests", those who are able to engage in complex financial and legal arrangements, those who underreport their income, those who do not pay taxes on a timely basis and users of services who do not pay for the benefits that they receive. Such favoritism is not warranted for two reasons: first, it is blatantly unfair to the taxpayer who willingly and honestly pays his fair share of the tax burden, and, second, as a substitute for direct rate reductions, it provides much less incentive for restoring our Nation's economic health.

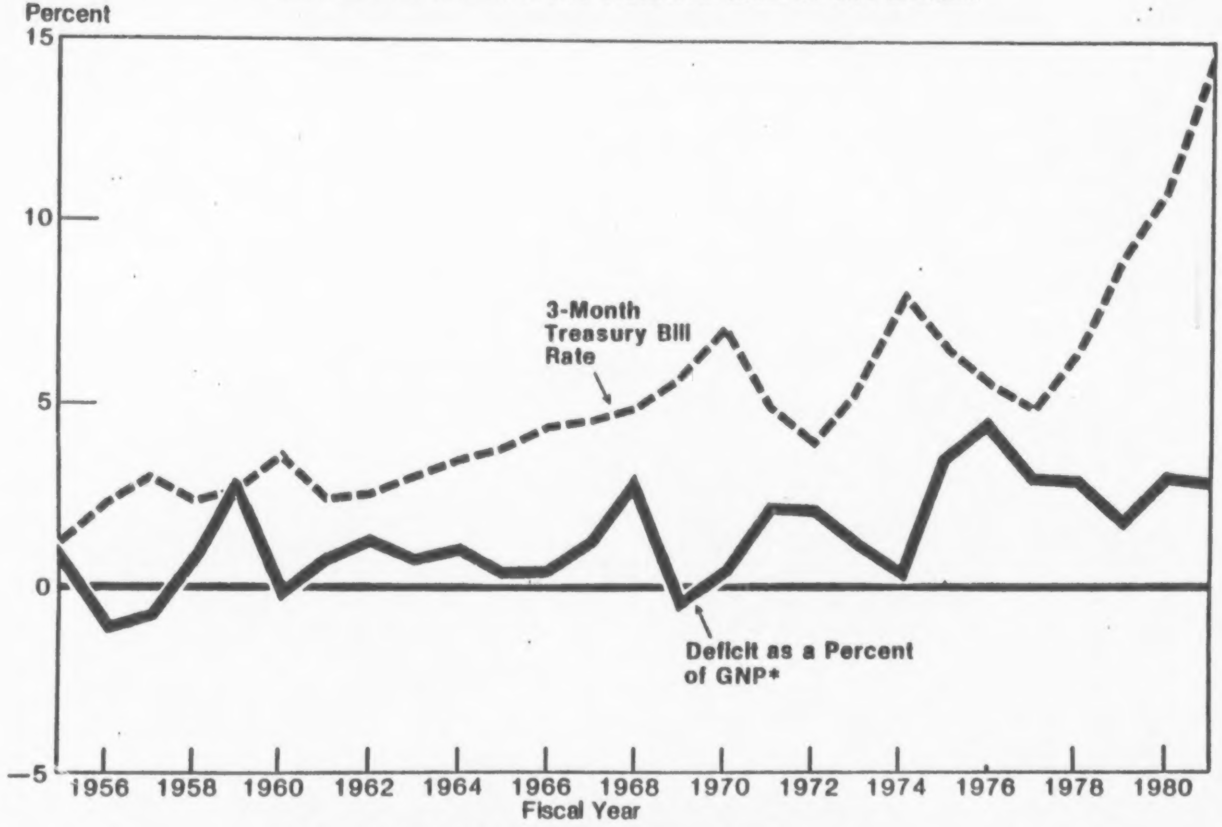
Mr. Chairman, I do not believe that most members of this Committee will favor special interests over the average taxpayer. I invite each member of this Committee to work with us on the proposals that I have outlined for you. Indeed, I look forward to your suggestions for ways to strengthen our efforts to eliminate abuses and obsolete incentives, to improve compliance and enforcement, to create enterprise zone incentives and to charge users of various Federal programs for the benefits that they receive.

Budget Deficits in Relation to GNP*



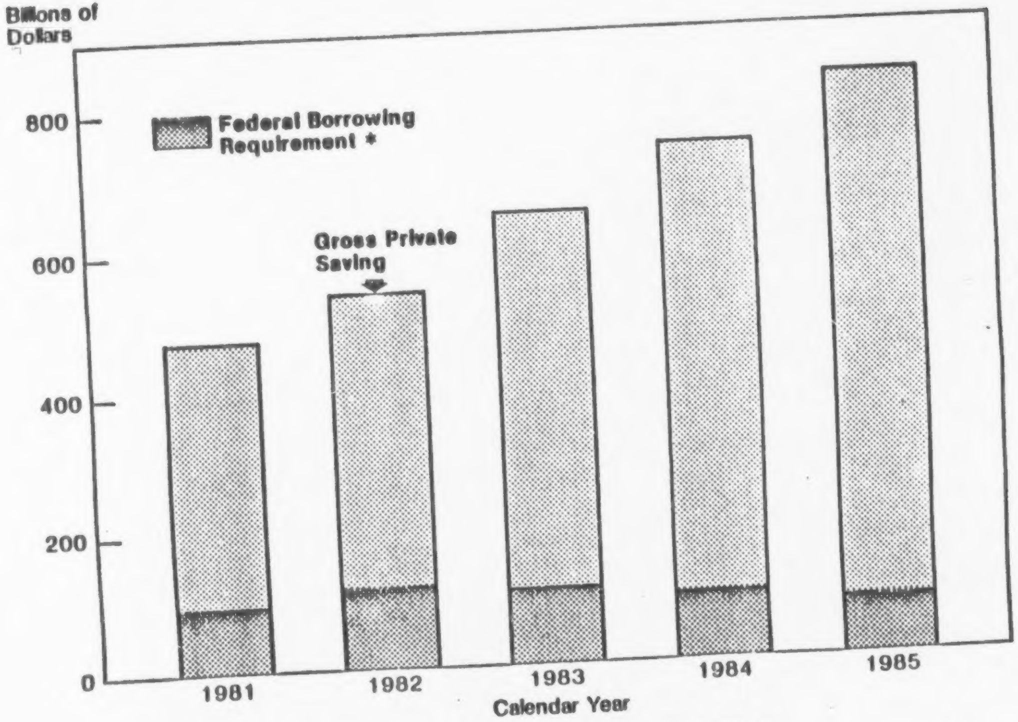
* On and off budget as percent of fiscal year GNP.

Interest Rates and the Relative Size of the Deficit



* Federal surplus or deficit includes off-budget items. Points below zero line represent surplus as percent of GNP, points above line a deficit.

Projected Borrowing Requirement in Relation to Private Saving



* Total calendar year budget deficit including off-budget entities.

Note: Saving flows do not reflect surpluses of state and local governments or inflows from abroad.

Chairman **Domenici**. Mr. Secretary, I know you do not have any advance information on inflation rates, but I understand it is just about time for a periodic reading of what the inflation rate is. Could you give us your best estimate now as to the rate of inflation?

Secretary **Regan**. The CPI will be coming out, I believe, tomorrow afternoon, Thursday afternoon. I have no advance information as to what that is. My best estimate would be that it will be again in the 5 percent, perhaps even a shade lower for the month, as it has been over the past 3 months. It has been running 5.2 over the last 3 months. I would assume it will be in that neighborhood again, on the CPI.

GIANT STRIDES MADE IN CONTROLLING INFLATION

Chairman **Domenici**. Mr. Secretary, the annualization of inflation would clearly indicate that we have made some giant strides in controlling inflation. However, the disparity between inflation and interest rates is in an absolutely incredible range. Generally it is what, a 3- to 4-percent difference?

Secretary **Regan**. That is the normal. Inflation plus 3 to 4 percent is normally what you could figure the short-term rate to be, and the longer term also.

Chairman **Domenici**. If that is the case, why are the interest rates in this country not responding?

Secretary **Regan**. Mr. Chairman, that is a major mystery. You can get all sorts of answers; let me try one. Some people call it the inflation gap or premium. Others call it the volatility premium. Still others call it the lack of belief premium.

With the prime, even though it was cut yesterday by some of the major banks to 16.5 percent, if we were to take an inflation rate of 7 percent and add to it the normal 3 to 4 percent, the prime should be somewhere in the 11-percent area now. I think everyone in this room and certainly millions of Americans outside would cheer a prime rate of 11 percent at this particular moment. But indeed we have a prime rate of 16.5 percent. There is the premium that I am talking about and that you suggested, Mr. Chairman. In the long-term rates, long-term treasuries currently are a shade below 14 percent since the recent decrease starting last Friday. Again, we have this unusual premium in the long-term rates. Even triple-A buyers now are in the 15.5, 16-percent area. So, they are paying the same type of premium.

How can we reduce this premium, I think, is what we have to look at rather than just why it is there. The answer has to be more credibility of us here in Washington. I think we are very much the problem. The administration's figures are not believable by a lot of people on Wall Street, as Senator Hollings suggested. We, however, believe that they are believable.

There are a lot of people who do not believe the Federal Reserve will stick to a steady course. And there are still others that wonder, in spite of what Senator Chiles and Senator Hollings heard from the business community the other day, if the Hill does change the tax bill this year, whether there will be more taxes for business. If so, how can business plan? So that uncertainty exists.

So, there is a lot of uncertainty going around, and that is what has resulted in the premium.

CONCERN PREDICATED ON SIZE OF DEFICIT

Chairman **DOMENICI**. Well, Mr. Secretary, unless you included in your lack of credibility the deficit—you did not mention it specifically you do not believe much of their concern is predicated upon size of the deficits?

Secretary **REGAN**. Oh, yes, that is what I referred to, Senator, and they do not believe our figures. They are not even sure that we will have the deficit as low as $91 billion, is what I am hearing. I could go through a tedious explanation of how deficits and interest rates do go in opposition directions. I would be more than willing to share that information with you. Nonetheless, there is this perception that deficits do cause higher rates of interest.

Chairman **DOMENICI**. Mr. Secretary, I believe whether it should be or not that the prime reason for the credibility gap now is, as you have expressed it, that they do not believe the deficit is as low as we say and as you say; but I think, even if it was as low as the administration predicts, that they still believe that it is too high. Now let me ask you to clarify something for us. In a budget briefing on February 6, you implied that the Federal absorption of savings would range between 10 and 20 percent. In testimony before this committee last September, the Chairman of the Federal Reserve in his prepared remarks showed that the percentage was nearly 50 percent. Now, that is generally referred to as the crowding-out theory. When we first started this committee, I think Senator Hollings will remember, crowding out was a theory. We used to hear people on our side constantly worrying about crowding out. I think the theory has become a reality.

I think if we are anywhere near 50 percent crowding out, meaning that the Federal Government will absorb 50 percent of the available savings, or even if it is not true and people believe it to be true, the reaction will not be to lower the interest rates.

VOLCKER SAYS 50 PERCENT OF SAVINGS BEING USED BY GOVERNMENT

Now, Chairman Volcker says about 50. You say 10 to 20. I have had our staff do theirs; they tend to agree with Mr. Volcker in that they do not think you have made allowances for the normal absorption for depleted capital stock that occurs both on the consumer side and on the private sector side that is not available for new growth. It may be available as an ameliorating factor if you were in a negative growth posture; I would not argue that. But to get to the 5 percent or 5.5 growth, you have to have new investment.

I think, if we are anywhere near 50, it explains exactly the dilemma we are in. I cannot see how the private sector being asked to grow can grow if we are anywhere close to 50 percent of the savings being used up by the Federal Government to pay its bills. Can you enlighten us on that, Mr. Secretary?

Secretary **REGAN**. Yes, this is all a question of the data and the method used for estimates on both sides, both the supply of savings and the demand for savings. By my calculation, there is a normal $50 to $60 billion of new savings each year. Add to that the saving due to the tax cuts of 1981. The entire business portion of those tax cuts will be saved. That is about 25 percent of the entire tax cut. For fiscal year 1983 it will amount to about $22 billion. In addition to that, you would have some of the individual tax cut being saved. Now, obviously, it is anybody's guess as to how much of that will be saved. We happen to think that approximately half will be saved. Even if it is as low as 40 percent that would be saved, putting it together with the other sources of additional savings results in an additional pool of savings in fiscal year 1983 of somewhere over $100 billion. Next year it would be even larger, and so on, out through 1985.

Based on these calculations, we do not see that the crowding out would occur. Even if there is greater than normal demand for financing investment, it could be satisfied primarily out of a shift from short-term borrowing into long-term borrowing, because there is and has been quite a bit of borrowing in the short term. When people move out of the short term into the long term, that is a show of confidence.

One other factor you have to take into consideration is the amount of foreign investment that is available here, not just domestic figures. You will recall that in the days of heady surpluses of OPEC in 1974, they bought as much as 35 percent of the new debt created in the United States. Now, with OPEC having reduced revenues, I do not think that OPEC would be doing anything near that in 1982, 1983, and 1984. Nonetheless, there is a large demand for American investments, particularly with the strength of our dollar.

I would say, Mr. Chairman, in answer to your question, that I would stick with my figures. I do not think that we will have crowding out as much as a lot of people feel it could be.

Chairman DOMENICI. I have just one remaining question. I will yield and ask you some questions at the end of the meeting.

REGAN STRONG PROPONENT OF MINIMUM CORPORATE TAX

Mr. Secretary, with reference to the tax proposals that you have sent up, one of them I feel very strongly about is the minimum corporate tax. Without going into detail, can you tell us whether you, in behalf of the administration, are going to be a strong proponent of that? It appears to some of us that everybody that makes money in this country ought to pay some tax whether they are corporate giants or whether they are the average American. I think we are bordering on leaving the impression with our people that we are not interested in equity. I think this is one small way to show that we are. We give many breaks; they have legitimate purposes. But, when you end up with a major company like Occidental paying nothing and you know they are making substantial real profits if not taxable profits, it seems to me that we have to move in that direction.

We are not the writing committee. I do not have to know the details. I really think it is important for us to know as we move through this what your thinking is about that kind of equity in the tax code.

Secretary **Regan**. Mr. Chairman, I personally am very much wedded to this idea. This is not new to me. I was saying this even when I was in the private sector and the head of a profitmaking organization. I think that each corporation should pay some type of minimum tax, just as I feel that any individual should pay some type of minimum tax.

I hardly need remind you gentlemen that a corporate minimum tax is already on the books. What we are proposing is that the items of preference that are now on the books are insufficient considering some of the other things that we have done for business. We should add preference items to those. I discussed this yesterday with the Senate Finance Committee. I told them that we have made certain suggestions regarding this. We are always willing to talk to business groups or to affected parties regarding our proposals as to whether or not they would have an adverse effect.

I also suggested to the Senate Finance Committee we would work with them on any proposals they had. But I do think, Mr. Chairman, that we must have a minimum corporate tax.

Chairman **Domenici**. I thank you, Mr. Secretary. I think we started our discussion with you hoping that there would be dialog with those affected so that the President would hear their voices, I want to say to you, while I hope you will hear from corporate America, I am sure they are not going to support you on this. But I think you ought to understand that we have millions of constituents going through this crisis who are literally earning nothing. Agriculture is very fragile, as you know. I hope you will not overlisten because, obviously, they will not want any tax. But I think, if you will stick to your guns, you will get plenty of support up here.

We have a vote. We will be right back.

[Recess taken.]

Chairman **Domenici**. The committee will be in order. Senator Hollings?

RAISING TAXES TERMED RIDICULOUS

Senator **Hollings**. Mr. Secretary, the President asked us in a very blunt way, put up or shut up. He said let's have an alternative. I worked on one and presented it. You described it as ridiculous. What was ridiculous about my plan?

Secretary **Regan**. Senator, the fact is that we took a quick study through our models of what the press report of your plan was. We saw what it did was to create more unemployment. It had a drag on the economy. And I could not understand—and that is why I termed it ridiculous—why we would want to raise taxes in the middle of a recession, as you were proposing. I thought that would be definitely self-defeating to have something of that nature happen.

Senator **Hollings**. I will go into that analysis.

Unemployment is a primary concern. High interest rates are what actually is causing it. You now in your statement, for example, say the recession is a legacy from the past. The opposite was true last February. You and others from Treasury said: Give us our program; you'll see an upturn in the very, very near future following the adoption of the President's program. They and you had projected a 4-percent growth rate in real GNP in the fourth quarter of last year.

The fact of the matter is that last quarter, instead of that robust recovery following the adoption of the President's program, you had the 5.2-percent decline and higher unemployment.

Now, that is not the legacy from the past. Even the President said he did not expect the recession.

Cannot you see what all business on Wall Street, what everybody in Merrill Lynch sees? That is that, yes, they have got the money. The program is there. The incentive is there. But with the Government running these high deficits, crowding into the capital market, they cannot do any long-range or should not do any long-range financing. The fact is that even small businesses are saying I will put it in money market certificates. I need some more trucks but, rather than buying the trucks and getting the equipment, additional payroll, additional insurance costs and everything else, everyone is swapping money around now. No one is really investing, either small business or in the stock exchange with these high interest rates.

INTEREST COST ROSE $23 BILLION LAST YEAR

Mr. Secretary, what do you think the rise in interest cost was on last year's debt as a result of the program? How many billion dollars?

Secretary REGAN. Do you mean higher than our projections, Senator?

Senator HOLLINGS. No. What was the actual rise in interest cost?

Secretary REGAN. We will have to get that figure for you. We do not have the exact amount with us.

Senator HOLLINGS. I asked. The staff and CBO worked it out: $23 billion. Now, we all struggle. I cosponsored with Senator Domenici the spending cuts. The spending for interest cost, the national debt, these went up $23 billion. Now we come to the next year, you are not getting the $35 billion in spending cuts. But you are getting a $31 billion increase in spending for interest. You are cutting out valid programs, but your interest cost is going up, up, and away. And therein is the catch-22 situation.

We are not really saving. You testified that government spending is still the enemy. But you are increasing more government spending than anybody else for interest costs.

We have got to get that deficit down. You can lower unemployment. People can get jobs and become employed if we can get those interest costs down. No one is investing in anything. No one is following through with the game plan of Reaganomics, all on account of the high deficit. Talking about economic figures and how deficits do not cause high interest costs; that might be some silly theory, but that is not the fact of life in 1982 in the United States of America.

Secretary REGAN. Senator, I disagree with you on a couple of points and agree with you on several that you just made.

MONEY SITUATION VERY VOLATILE LAST YEAR

First of all, I do agree with you that high interest rates are the key to our economy. I think that is a given. I recognize what high interest rates have done to many industries in this country. In coming back now to why were interest rates higher last year and did we cause that, I would have to disagree with you; by we, I mean the administration. I think that what happened here was that we had a very volatile money situation last year. We had interest rates up at 21.5 percent in January, when there was an astonishing 13-percent growth in the money supply during that first quarter. The money supply was brought down to practically zero over the next 6 months. Later, in the last 2 months of the year, it shot up again, as a matter of fact, during the month of January to a 20-percent increase.

This volatility had an unnerving effect on the money markets and kept the premium part of interest rates up. It was not just the deficits. The deficits themselves do contribute to these unusually high rates of interest, but it is not the only cause. Even if the deficits were at zero, if we had money supply growth at zero, you would still have high rates of interest because of the volatility on uncertainly premiums. So, you have to balance these in your mind as to exactly what is causing what.

Now, as far as the Reagan administration and the recession is concerned, I do think that we inherited the recession. Our program was not voted by this Congress, as you well know, Senator, until July nor signed into effect until August. Yet, the recession started in July. So how could our policies, our program have possibly caused a recession that started before our program was enacted?

MONEY SUPPLY COULD FALL

Senator HOLLINGS. In that staff analysis of my particular program, you assume that the money supply would fall by 10 percent by the end of 1985. Do you feel that that is a fair analysis?

Secretary REGAN. Fall by 10 percent?

Senator HOLLINGS. Yes.

Secretary REGAN. If you are talking about a fall of 10 percent of the money supply growth from approximately 5 percent, there would be a half a percentage point drop to, 4.5 percent, yes, I would agree with that. The money supply growth could fall from 5 to 4.5.

Senator HOLLINGS. Going right to the elements of defense, entitlements and the tax cut, do you think trying to hold in place the 1982 defense budget for the year 1983 would cause high unemployment? If so, how many jobs, do you think?

Secretary REGAN. May I have that question again? I did not quite follow it, Senator.

Senator HOLLINGS. The elements of my plan, you say, are going to cause high unemployment. I am going to the three main features of it: the defense freeze, the entitlements freeze, and the tax cut freeze. How many jobs would be lost by freezing the defense budget at the 1982 level for 1983?

Secretary REGAN. I would have to ask an expert on that. I am not that familiar with the DRI model and the effect of defense on the model.

In working on the model software, we did not break it down by sector. Unemployment would rise to 8.9 percent, as a result of your overall program, not by sector.

DEFENSE HAS $33.6 BILLION UNOBLIGATED BALANCE

Senator HOLLINGS. The fact of the matter, do you realize that they have actually $33.6 billion in unobligated balances right now at the Pentagon in defense?

Secretary REGAN. I have heard that figure, Senator.

Senator HOLLINGS. Do you realize if you adopt the defense budget proposed by your administration, that unobligated balance would go back up to $43.1 billion?

Secretary REGAN. I am not familiar with that. I have not——

Senator HOLLINGS. If you look at the President's budget on page 9.9 you will find those figures in there. This is the dismaying thing. Here is a department of Government with $43 billion, $33 billion now, hanging around; and you are going out in the open market and borrowing it. Why do not you call up Cap Weinberger and get it out of his petty cash drawer?

Secretary REGAN. He does not have the actual cash there. That is unobligated budget authority. There has been no obligation by Congress of that authority as yet. There is no money lying there fallow.

Senator HOLLINGS. That is not authorizing amounts; that is the actual unobligated balances in outlays in the particular Department. I had to defend it back in 1976, when it was $12 billion. I tried to explain it. Those are the funds that are there now, and they needed it for contracts.

I think you ought to look at that when you start talking of unemployment because I think your program is causing more unemployment. The interest rates keep going up, up, and away and the economy appears frozen in place.

I have one final question. I guess I am through with my time. The contention that we ought to let the President choose his own Chairman of the Federal Reserve Board so they could work in tandem. What is your reaction to that suggestion?

Secretary REGAN. I have not studied that too much. That was a proposal that was made back at the time of, I think, the Nixon administration. That proposal also surfaced under Dr. Burns. When he was head of the Federal Reserve, he testified in favor of it.

It has a lot to be said for it. When a new administration comes in, they would have a new Chairman for that Board the same as they do for any other board. That is not to say—and I would not want my remarks misinterpreted—that our relationships with the current Chairman are not that good. I think that we do see eye to eye on policy in the Federal Reserve, maybe not in practices in some respects.

TARGET FOR GROWTH OF MONEY SUPPLY IS 5.5 PERCENT

Senator HOLLINGS. What targets would you set for the growth of the money supply if you were in charge of it?

Secretary REGAN. We have suggested that the Fed's target of 5.5 percent, the upper third of the bracket, is agreeable to us. If they will stay somewhere in that 5-percent area this year, we feel that there will be enough money to help us out of the recession.

Senator HOLLINGS. It is your contention that spending $100 billion by going out and writing it in red ink, going out and borrowing it, is going to cause less unemployment than actually saving that $100 billion in the budget for 1983?

Secretary REGAN. No, I did not say that.

Senator HOLLINGS. Well, my plan proposes just to save that $100 billion.

Secretary REGAN. Yes, but you raise that by taxes, by additional taxes.

Senator HOLLINGS. No, no, no. I keep the tax level. That law has not taken place. You folks talk very, very loosely. I deny, yes, I defer the tax cut. I do not increase anybody's tax.

Secretary REGAN. Well, that would increase people's taxes.

Senator HOLLINGS. No, that would keep it just the same level. It would not give them a decrease.

HIGHER BRACKETS REACHED BECAUSE OF BRACKET CREEP

Secretary REGAN. No, but because of bracket creep, each one of us is being pushed into a higher bracket constantly——

Senator HOLLINGS. By inflation and high interest rates.

Secretary REGAN. Right. But each one of us will therefore pay more taxes. What the Reagan tax proposal in 1982 does is to bring you back down to the 1981 level. If you do away with the 1982 increase, you push the person back up to the higher level.

Senator HOLLINGS. If you wanted to talk on that basis, we have also got bracket creep in Government programs, and you mentioned nothing about them. The entitlement programs creep up because of inflation.

Secretary REGAN. We have made some suggestions on entitlements. Cuts in entitlements are about $12 billion in the fiscal year 1983 budget and increase in the out-years.

Senator HOLLINGS. Yes, but that is nibbling around at medicare and capping health costs and everything else, which everybody has been trying to do. But actually getting into the cost-of-living increases, you have not touched that at all. That is the real creep that we have.

Secretary REGAN. Well, we are waiting for the Social Security Commission to report on their suggestions on COLA's.

Senator HOLLINGS. I thank you, Mr. Secretary.

Senator KASTEN. Mr. Secretary, I want to talk about the so-called interest premium that you discussed with Senator Domenici. I think the one thing that people do not understand is the fact that we seem to have inflation under control, but interest rates have not come down.

CREDIBILITY PROBLEM

I think the real issue is our lack of credibility. You suggested that yourself. It is not necessarily that the figures are not believable. It is that people believe the figures they see, and they do not like what they see. They see deficits that are high and higher. They are worried about crowding out. They are concerned about what is going on. The problem is kind of a "politician's premium," in that they simply do not believe us. They do not believe that the politicians are going to have the political courage to control the entitlement programs, which we have "uncontrollable."

I do not think that the American people believe that we are going to have the political courage to give the same kind of scrutiny to defense spending this year that we gave to the spending in the domestic programs last year. Those two elements, where they are seeing large rates of increase, are of concern.

My question to you is, will you lead us into examining these areas? So far the administration has been very reluctant to support any efforts, whether they are from Senator Hollings or from Senator Domenici. I know in the last few days you have had an opportunity to review the proposal that I am in the process of developing. Will you assist us as we give the same kind of scrutiny to defense spending? More importantly, will you assist us as we seek to freeze or to delay the entitlement programs which include social security?

PRESIDENT WILLING TO LISTEN TO OTHER SUGGESTIONS

Secretary REGAN. Let me speak from two angles here, first of all from the Treasury Department's angle and then later from the administration's point of view. From the Treasury Department's angle, of course, obviously, we will provide any technical help we can give for you or any other Senator working on the effects of a tax proposal of either small or large proportions. We would be more than willing to do anything we can in the technical area to work with you to give you the figures that you may need in following out your thought process.

Now, as far as the administration is concerned, what the President has said is that he is willing to listen to any comprehensive package that this Congress might develop. He did not say he would accept it. He did not say that he would buy it. But he said that, if there were other suggestions, he would look at them.

Senator KASTEN. My proposal for entitlements would delay COLA increases 3 months in each of the next 3 years. We have been reviewing this proposal with you, your staff, with OMB and others. If we can develop a consensus for a delay, would you and the administration work with us and accept that kind of a change in an effort to get at these ever-growing deficits?

Secretary REGAN. Senator, what I said was we would be willing to study that proposal. I did not say that we—I said we would work with you in developing the figures. We would then study your conclusions based upon those figures. I did not say we would accept it.

Senator KASTEN. But we are in a position in which, as you understand, the administration's proposed budget will be changed by this committee and the entire Congress. Are you saying that within that process you are not rejecting our ideas to cut or freeze or to slow down certain kinds of entitlements?

Secretary REGAN. Well, I think I would draw an analogy to what happened last year. I can speak from my own experience here in the tax area rather than in the budget area on the outlay side. We came up with certain proposals, the President's tax program. It was modified. We worked with people up here on the Hill during that process. In the final analysis, the President did accept it.

What I am suggesting is that, sure, we will work on it, work with you to help you get the figures and the facts and then study it. If it is acceptable, yes. If not, no.

TRAGIC MISTAKE MADE IN TAX PACKAGE

Senator **Kasten**. I happen to feel that we made at least one tragic mistake in that tax package last year, but I do not want in any way to diminish the importance of——

Secretary **Regan**. Perhaps more than one.

Senator **Kasten** [continuing]. Your answer.

I want to just talk about that for 1 minute. As you know, we are developing a plan that will lead to a balanced budget in 1985. It also will speed up the tax cut from July to January in 1982 to 1983. That is a static loss of $17 billion in each year. According to the U.S. Chamber of Commerce, it looks as if the revenue reflows would be $5 billion.

If we had the original tax cut plan of 10 percent, 10 percent, 10 percent in each of January 1981, January 1982, January 1983, then is it not true that the recession would be a lot milder and that we would have the ability to propel ourselves out of it in a much more rapid way?

Secretary **Regan**. I think definitely the 10 percent coming earlier in 1981 would have been very helpful in ameliorating if not avoiding the recession of 1981. I think that I could not speak until I see what the effects of the July 1 tax cut will be on the economy as to whether it would have been better to have it January 1 of 1982 or July 1 of 1982. But I definitely feel that you are right in that would have been very helpful if the original 10 percent had come in 1981.

Senator **Kasten**. Mr. Secretary, I hope that you can work with us as we work to speed up the tax cut and also a cut in entitlements. If we could do those two things, we would certainly be on the right track in dealing with this credibility problem that we have.

I was hoping that Senator Domenici would be back by now so that we would not be wasting your time. He will probably be back in a couple of minutes. At this point the committee is recessed.

[Recess taken.]

Chairman **Domenici**. The committee will be in order. Senator Chiles?

STRONG ECONOMIC RECOVERY SOUGHT IN HOUSING INDUSTRY

Senator **Chiles**. Mr. Secretary, I think I raised some of the points I am interested in in my opening statement when I was talking about housing. I wish you would try to tell us how we are going to get a strong economic recovery given the plight of the housing industry today and the proposals in the budget which would reduce virtually all of the programs that could be used to promote housing.

Secretary **Regan**. The problem with housing, as the Senator knows, is the problem of interest rates. No builder can build with or without Government subsidies if he has to pay 17 or 18 percent for construction loans. You are simply not going to be able to get people to do it. Even if a person were able to build homes at that interest rate, if somebody has to put 20 percent down and then the carrying charges with the mortgages at 17.75 or 18 percent or more, the amount of a person's income that would be eaten up in just monthly payments on interest alone would be close to 40 percent of their available income. So, no one can possibly afford to buy a home with that kind of interest rate.

Our problem is to get interest rates down just as quickly as we can in order to get that revival in the housing market. Now, it would be really a budget buster for us to try to subsidize housing again to make loans available at 12 percent or somewhere in that neighborhood in order to revive that industry. That is what I was referring to in my earlier remarks, the quick fix that presents more problems to us.

Senator CHILES. It is one thing to talk about adding money to subsidize housing to get interest rates down to 12 percent. Another thing is, at a time you are going through the chaos that we are, to turn around and cut out the current Ginny Mae programs and make tremendous cuts in the FHA programs. That would certainly seem to be self-defeating, I think.

Of course, what we are really talking about doing is reducing the size of the deficit. That is how you can do something to get the interest rate down. Your particular cuts are not reducing the size of the deficit anywhere near what has to be done to get interest rates down. When I apply realistic estimates to your proposals, it looks to me like the deficit would grow to $140 billion by 1985, instead of dropping.

COMPETITION IN THE MARKETPLACE

Secretary REGAN. Well, to the extent that we have those programs, they are competing in the marketplace. We would rather have the private marketplace out there doing that business. I think in the mortgage money market.

Senator CHILES. Is there any competition for mortgage credit now? No, there is not any right now. Housing has stopped.

Secretary REGAN. But remember we are talking about the 1983 budget. We are not talking in terms of February 1982.

Senator CHILES. Well, you propose to take the first $20 billion cut in 1982.

Secretary REGAN. Well, if you would insist that we have the fiscal year 1983 budget in place now, you would have to have some type of supplementary to change it.

Senator CHILES. Well, that is your proposal, though, that you made in this budget, to make a further cut this year.

Secretary REGAN. That is right, in the 1983 budget.

Senator CHILES. No, in the 1982.

Secretary REGAN. I am unaware of that. I would have to refresh my memory on that particular one, on the 1982 budget.

Senator CHILES. Well, it is in the budget on page 5-66: I quote, "major proposed reduction in Federal loan guarantees in 1982 include $20 billion in the commitment level of the Government National Mortgage Association, the GNMA mortgage backed security programs and $1 billion in the authorized guarantee commitment levels for Small Business Administration."

Secretary **Regan**. What page is that, Senator?

Senator **Chiles**. It is page 5-66.

It is proposed for another $10 billion cut in 1983.

Of course, in this program there is no subsidy and no outlay.

UTILIZE RESOURCES OF PRIVATE MARKETS

Secretary **Regan**. Well, you can certainly see, reading on there, what we are talking about, which is to utilize private markets to allocate resources rather than have Government do it.

Senator **Chiles**. Well, the resources in the private market—and, again, that is where we are talking about this tremendous high interest rate that we are facing now.

Secretary **Regan**. Take a look, Senator, at what the VA and the FHA mortgage rates are right now. They are 17.75 percent. I submit, even with a Government rate of 17.75 percent, nobody can buy a home. That is my point.

Senator **Chiles**. Well, that is a point regarding the deficit that we have been trying to make, too.

Secretary **Regan**. That is why, Senator, we say that we do have to get these deficits down. Under our proposal we think that interest rates will come down.

Senator **Chiles**. You have been saying that we would get a strong recovery this spring and summer. Yet, you have also been saying we should not touch the second and third rounds of the tax cuts for fear of hurting the economy. While it is very attractive politically to go with the phrase "don't raise taxes in a recession," is it not a fact that most of the fiscal impact of the July tax cut is going to be left in calendar year 1983? And that is after you say we will be out of the recession and into the recovery. So, would we not once more be going into the same cycle as the past, cutting taxes in the recovery and adding to inflation.

Secretary **Regan**. That is right, Senator, you will be doing exactly the same thing.

Senator **Chiles**. Nixon, Ford, Carter——

Secretary **Regan**. Raising taxes just as the recovery gets started, you would give it about a year, raise taxes and, boom, down would go the economy because you take the incentive out of it. There would be no savings left there. If you do not have a tax cut, where do you get the savings from individuals?

Senator **Chiles**. We are talking about whether we are going to delay the extra tax cut in order to get interest rates down.

TAX CUT WILL NOT LOWER INTEREST RATES

Secretary **Regan**. Delaying the tax cut is not going to get interest rates down because delaying the tax cut means that the Federal Government will then take that money from citizens and spend it. They will not save it. If you give the money to the citizen, he can save it. Let me show you a chart, Senator, that explains what happens.

Senator **Chiles**. What is to keep us from reducing the deficit rather than spending?

Secretary REGAN. Based upon prior experience——

Senator CHILES. We are not talking about prior experience; we are talking about the Reagan administration now.

Secretary REGAN. Let me show you, sir, what you would be doing to a $20,000-a-year worker in Florida or anywhere else, if you delay that tax cut. This is the path—that we are on now—of what the tax cut for that individual will be. You delay that tax cut in 1983, and here is the extra amount of taxes that he will be paying in 1984, 1985, and so on. The lost tax reduction is somewhere in the neighborhood of $300 to $400 annually, $1,400 over this period. That is for a family of $20,000 income with four individuals.

BUSINESS PEOPLE ARE SAYING GET THE INTEREST RATES DOWN

Senator CHILES. That is an awfully big curve for $300 a year. But you know what I am hearing from those people that are in business? They are saying:

> Look, I don't have to worry about taxes; I'm not making any money; I'd be willing to pay some taxes if I can make some money; do something to get the interest rates down so I can make some money, and I'll pay my taxes. You're giving me a tax cut at a time that I can't make any money. My business is broke. I can't borrow any money to pay the bills that I've got, and so I'm going flat broke. And now you're talking about giving me a tax cut.

Secretary REGAN. There are 97 million Americans employed, and that is the people we are talking about. These are the taxpayers of the United States, and that is what you would be doing to them if you delay that tax cut. It is not just the small businessman who may not be making profit. It is the wage earner who is earning wages.

Senator CHILES. You know, it is funny that we do not hear from any of those wage earners that you have to give them a $300 tax cut. They are really saying do something about interest rates.

Secretary REGAN. They are certainly not saying please raise my taxes.

Senator CHILES. No, but what they are saying is get the interest rate down.

Secretary REGAN. I agree with you. I said that to the chairman. I said it to Senator Hollings. And it is one of the things we are trying to do. That is the No. 1 problem facing us today.

Senator CHILES. We agree on that. It is just a question of how we get the deficit down.

Chairman DOMENICI. Thank you, Senator Chiles. Senator Grassley?

Senator GRASSLEY. Thank you, Mr. Chairman. First of all, I would like to put a statement in the record.

Chairman DOMENICI. It will be made a part of the record.

PREPARED STATEMENT OF SENATOR GRASSLEY

Mr. Secretary, I am shocked at the amount of support among Senate Republicans, especially on this committee, for repeal of the 25 percent rate reductions. If some of these Senators had their way, they would repeal half of the Economic Recovery Tax Act. They talk as if the tax cuts have produced the huge deficits we now face.

It is quite clear to me, Mr. Secretary, that these deficits are the result of an economic slowdown. And it therefore follows that the solution to closing those deficits is to produce our way back to balance.

In the unfolding debate, here, about the Federal budget for 1983 and beyond, I have heard only one Senator, Bob Kasten of Wisconsin, speak to the need for economic growth.

We need economic growth, and we're not going to get it by raising taxes. Nor are we to get lower interest rates by raising taxes.

We need savings, capital formation and productivity. Where would these come from if taxes were increased?

I happen to have a study right here, done by Data Resources, which analyzes the effects on the economy of the Hollings budget proposal.

The Hollings plan would repeal the 1982 scheduled tax cut, and cut in half the 1983 tax cut. It would also eliminate indexation of tax brackets.

According to DRI, this proposal would reduce income for the average American family by $4,000. Unemployment would soar to 11 percent, putting 4 million more people out of work. It would increase taxes by $200 billion over the next three years.

Mr. Secretary, an increase in taxes is not the answer to bringing down interest rates. It would merely shut off the tax relief that workers and small businesses have been promised by Congress and are depending on in this recession.

Repeal of the individual rates and indexation would leave the average worker, saver and entrepreneur with absolutely no protection against continued inflation and high interest rates. Above all else, it is my belief that we must keep these two provisions intact.

And my constituents feel the same way. They wonder why tax cuts were OK last year, but this year they are not. We are sending them the wrong signal about the direction of our economic policy. And to me, that is nine-tenths of the battle.

So today I would like to reaffirm my intentions to stick to the tax policy that I voted for in 1981. And I would reinforce the notion that to reduce these large deficits we must look at the spending side of the equation where the deficits have grown. We must not lost sight of the importance of savings and productivity in our efforts to achieve economic recovery. And most of all, we must not renege on our commitment to provide real tax relief to the American people.

Senator GRASSLEY. Mr. Secretary, recently it was reported in the Washington Post and, I suppose, in other newspapers as well about the Business Roundtable and also some lobbyists for business groups that were testifying on the extent to which the personal tax cuts ought not to take effect particularly in 1983. I guess I ask you this because of your background in the business community and whether or not your administration would lend any support to that. I guess, frankly, I would like your personal views of what you think about forgoing the tax cuts as opposed to if anything is done about the individual tax cuts that maybe something also ought to be done about the business tax cuts so that just the individual worker is not paying a higher tax bill while business had its tax cuts left in place, as the Business Roundtable presumably implies here.

Secretary REGAN. First of all, the administration and I personally do not agree that we should change the individual tax cuts, the 5-10-10 program that is already in place. I am rather surprised at the business community suggesting this. I think the proper way to get the deficits down is to cut spending. The growth of the Federal Government is the thing that worries me. Without the proposed outlay cuts as a percentage of GNP, we could be on a rising curve rather than a declining curve, as far as the Federal Government's take of our gross national product.

Obviously, I have to remind the business community, as you suggested in your question, Senator, that, if there are cuts in individual taxes, there certainly would be cuts in—I mean increases in the individual taxes, there certainly would be increases in business taxes. I do not think you could possibly have one without the other.

Senator GRASSLEY. Thank you very much.

FORGOING TAX CUTS WOULD BE SERIOUS PROBLEM TO SAVINGS RATE

A second point deals with whether or not we would forgo either the July 1, 1982, or July 1, 1983, tax cut, and I do not support that, by the way. But let us suppose we would not have it go through. What do your studies tell you or what is your personal view on what that might do to the unemployment situation, if anything?

Secretary **Regan**. I think that what we would have here would be a very serious problem as far as our savings rate in the United States is concerned. I think that people are just getting now to the point where they think: Well, maybe if I get a tax cut, I should start to save more. We have noticed the savings rate went, for example, to about 6 percent in the final quarter of 1981. I think that is due to a combination of things. First of all, of course, is the fact that we were in a recession. Our people were hearing about their neighbors being unemployed. They decided to save more. At the same time, we did make the first of our tax cuts.

I think that the savings rate will probably increase in 1982. Now, if we do away with the tax cut, I think we will not, obviously, have as much savings. We will not have as much consumption because the Federal Government will be taking it. I think that a dollar spent in the private sector gets a lot more growth into gross national product than a dollar spent in the Government sector.

So, I think that the proponents of a tax increase are asking for a continuation of this current recession.

TAX CUT NECESSARY TOOL TO GET OUT OF RECESSION

Senator **Grassley**. So, then the tax cut July 1 is a necessary tool to get out of the recession?

Secretary **Regan**. Very definitely. As I said before, we are very well positioned, very fortunate to have that tax cut coming at that time. That is $30 to $35 billion that will be going into the private sector over a period of 12 months. In addition to that, of course, we will have the social security benefit increase due to indexing of about another $11 to $12 billion. So, you will have somewhere in the neighborhood of $45 billion coming into the economy over the next 12 months, starting July 1, 1982.

Senator **Grassley**. Would it be that right now just the knowledge on the part of workers and savers that the tax cuts going to be effective July 1 have some beneficial impact immediately like today in anticipation of it going into effect? Or do you anticipate that we have to wait until we get down to the point of July 1?

Secretary **Regan**. I think some people will anticipate that they are going to get the tax cut, but I think a lot of other people hearing of our conversations up here will be a little bit apprehensive as to whether they could count on actually getting it. I think that again is one of the problems, as I suggested earlier in answer to Senator Hollings, with the business community. They are worried as to whether or not the business portion of ERTA is going to change.

Senator **Grassley**. So, we are doing some harm by having the possibility open of changing the tax bill the last year?

Secretary **Regan**. Yes. That is the uncertainty factor that comes into the marketplace.

Senator **Grassley**. Have you ever made any attempt to measure that? Or is it impossible to measure?

Secretary **Regan**. I do not think you could measure it, Senator. From my own practical experience, if you were thinking of making a major investment and you thought that maybe there were going to be changes here or changes there, would you wait 5 months or would you not, particularly if faced with high interest rates and thinking that maybe interest rates would come down. I think that is what has happened to investment in America.

Senator **Kasten**. I think Senator Metzenbaum is next.

Senator **Metzenbaum**. Thank you, Mr. Chairman.

DIFFERENCE OF OPINION EXISTS BETWEEN REGAN AND VOLCKER

Good morning, Mr. Secretary. You made the point that you and the administration and the Chairman of the Fed are pretty much in agreement with the objectives but not in the method. Does that mean that, when Mr. Volcker yesterday talked about and said that he preferred higher taxes to the proposed deficit, you consider that just a matter of means and not a question of the objective, and the objective is to get the deficit in balance and the economy better off? What do you mean by that? It is such an obvious confrontation.

Secretary **Regan**. No, I do not think there is an obvious confrontation, Senator. He there was replying to questions concerning fiscal policy. I was referring more to monetary policy when I, in answer to a question, said that we are in general agreement with them. I was referring in particular to the policy of the Fed last year that money supply growth should come out somewhere between 6 and 8 percent. Well, unfortunately, they hit it on the low side. It came out somewhere in the neighborhood of 4.5 to 5 percent.

This year their target for M_1 is 2.5- to 5.5-percent growth. I am suggesting that we are satisfied with that policy if they hit the upper third of the target range. What we objected to last year and have urged the Fed not to do—and this is nothing new that I am saying because we have said this time and time again during 1981—is to get the volatility out of the money supply as much as possible.

Senator **Metzenbaum**. I know but you said in your statement that deficits do not cause high interest rates. And Mr. Volcker has said that he dismissed the argument advanced by some administration officials, particularly Secretary Regan, that U.S. savings are going to rise so much under the impact of the new tax laws, that large deficits will be financed easily.

Now, that is really quite opposite what——

Secretary **Regan**. Well, that is not a confrontation; that is a difference of opinion. In that I do differ from the august Chairman of the Federal Reserve.

Senator **Metzenbaum**. OK, at least we agree upon that. It is a difference of opinion and not a confrontation.

ZERO IN ON OIL COMPANY TAX LOOPHOLES

Now let us go back a year ago. At that time I had said to you that I never found anybody who wanted to pay taxes whether they were 70 percent, 50 percent, 30 percent, or 10 percent. You indicated that the best answer to the question of tax loopholes is to knock all of those so-called tax loopholes by getting the tax rates down to where it is not worthwhile. And I know that you have alluded to the question of tax loopholes in your statement. I know that the budget has some reference to it, but it is tweedle-dee tweeddle-dum compared to the totality of the problem. As you well know, Boardroom Reports and other kinds of managemenet journals are now saying that the outlook is bright for taxpayers who find the right tax shelter. While it is true that tax shelter losses will be worth less next year when the top individual tax rate falls from 70 percent to 50 percent, there are mitigating benefits under the new law that greatly favor shelters.

Mr. Goodman of Leopold & Linnow says that investments in tax shelters are particularly attractive in the current year.

My question to you is this. Is not it time that the administration really takes a hard look and tries to help us eliminate a substantial portion of the budget deficit, maybe as much as $25 to $35 billion, by actually zeroing in on some of the major ones such as the oil company tax loopholes, tax shelters, tax expenditures, which would be worth $53 billion to us in 5 years? As you well know, between 1978 and 1980 all of the profits of this country, all the increases, $19.6 billion, 98 percent of that went to 44 oil companies, and since 1980 it has even been worse.

Under those circumstances, is not it right that we require the oil companies to pay a fair share of the taxes? And you have got nothing in your program that would cause that to occur.

Secretary Regan. Well, that is a very lengthy subject, as to what is a proper tax rate in order to avoid tax sheltering. What is one man's tax shelter is somebody else's tax abuse. It is very difficult to try to be philosophical or precise in this area without an entire study of the entire taxation system of the United States.

CHANGE IN CORPORATE PREFERENCE ITEMS SUGGESTED

Senator Metzenbaum. You said that first when you came here only about a week or two after you had been sworn in. You said it takes us time. Now over a year has passed. The American people are saying we are willing to pay our fair share; we want things to be fair and equitable. And there is no effort to move in on the oil companies, the timber companies, the island corporations, the banks that have special privileges, no effort at all, not a peep out of this administration and even some objection to repeal of the safe harbor provisions.

A man like Senator Quayle says that soon 50 percent of the corporations of the country will not be paying any income tax.

Are not we entitled to something more than that from an administration if they are to be fair and equitable?

Secretary Regan. Senator, unfortunately, the full details of our corporate minimum tax proposals have not surfaced, although I have discussed this in public with the Senate Finance Committee. We are suggesting that corporate preference items be changed as far as figuring the minimum corporate tax. As you know now——

Senator **Metzenbaum**. Is not that just a few billion dollars, though? That is all you are really talking about.

Secretary **Regan**. No, it is a little bit more than a few billion. It is somewhere in the neighborhood of, I think, $7 billion——

Senator **Metzenbaum**. Not a year.

Secretary **Regan** [continuing]. Is what we are talking about in the next 2 years.

Senator **Metzenbaum**. The oil companies are $53 billion—5 years.

Secretary **Regan**. Well, again, now, if you come back to the oil companies, you would have to make an entire change as far as foreign tax income is concerned. You would have to go into whole new tax treaties, ideas of that nature in order to change.

Senator **Metzenbaum**. Not the intangible drilling cost, not the oil and gas depletion, not the State exemption of windfall profits. You would not have to do any of those. You are only talking about 25 percent on the foreign tax credits.

INCENTIVE BUILT INTO TAX PROGRAM

Secretary **Regan**. Well, if you want to get into those, what are you going to do? Are you going to do the same thing for all of our mining, all of our timber? In other words, you are going to give no incentives to anybody to do any kind of drilling. What then happens——

Senator **Metzenbaum**. They are getting all the profit——

Secretary **Regan** [continuing]. To the oil supply in the United States? You see, that is the incentive that Congress built into the tax program 30, 40, 50 years ago and has never changed; the incentive to drill for oil in the United States, which gives the owners of wasting assets the right to deplete them.

Senator **Metzenbaum**. Mr. Secretary, I would like to inquire further of you, but I want to abide by the committee rules; the red light is on.

Chairman **Domenici**. I have been out of the room, but I understand that Senator Riegle should be next; but he is not here. Senator Exon?

Senator **Exon**. Thank you, Mr. Chairman.

Mr. Secretary, yesterday Mr. Stockman testified before our committee that the recession and the economic assumptions on which we based our budget last year and our tax policies have been all upset because no one anticipated the basic recession. I assume that you generally agree with that.

Secretary **Regan**. Yes, Senator.

Senator **Exon**. If that is true then, a year ago now, when you and the administration were pushing hard for the massive tax cut, would you still have pushed for that then had you known that basically as a result of that action we would be facing the staggering, record-breaking deficits that we are facing now?

RECESSION STARTED BEFORE TAX CUT

Secretary **Regan**. I have to disagree with you that as a result of the tax cut we are facing a recession now. That tax cut, as I reminded some other Senators in answer to a question, as I recall, was passed by the combined Houses around July 31 and signed by the President on August 8. The recession actually started the first part of July, according to the National Bureau of Economic Research. So, since ERTA had not even been passed, I do not see how it could have caused the recession.

Actually, if I had known that there was going to be a recession of this dimension in the final part of 1981, I would have pushed harder for that 10-percent cut to come into effect on January 1, 1981, in order to have that tax cut in place to ameliorate and perhaps eliminate the recession.

Senator EXON. I think one of the broad differences between many of us who are conservative on fiscal policy and the administration is the fact that every time we talk about the tax cut you indicate that has nothing whatsoever to do with the staggering deficits. Now, you do not mean that, do you?

Secretary REGAN. I did not say that. I said with the recession. It did not cause the recession. I did not say it caused—did not cause part of the deficit.

Senator EXON. Maybe I misstated. Let me ask you again. Do not you think the massive tax cut has a great deal to do with the record deficits that we are facing right now?

TAX CUT NOT CAUSE OF DEFICIT

Secretary REGAN. We actually have an increase in taxes in 1982 over 1981 and even more of an increase in taxes in 1983 over 1982. It is not the tax cut of itself that is causing deficits. Actually in point of fact, we are going to receive more revenue in each of those years. It is the failure to cut as much out of the Federal budget that is causing most of the deficit.

Senator EXON. I am sure that you know how to read a balance statement. I am sure that you also know that, whenever you talk about balancing a budget in private business or in your home or in Government, that talks about matching income with outgo somewhere along the line. The facts of the matter are you cannot get away from that. Regardless of whose fault it is, expenditures continue to go up. As a result thereof, we have not only a record national debt of over $1 trillion at the present time, but we also have the greatest deficits in the history of this country.

You know, this administration that came in promising to balance the budget is going to indeed have the record of presiding over the greatest deficits in the history of this country.

I suggest to you—and I wish that you and the administration would admit it—that at least a part of that has to be because this administration is not recommending the raising of enough revenue to help reduce the deficits. You keep saying every time it comes up—and I do not know whether the press understands it or not, but every time it comes up this administration ignores the fact that you are not raising enough money to balance the budget, and you say cut more. It may be a political scapegoat, but it does not do very much, Mr. Secretary, I suggest, for the economy and the high interest rates that are troubling this country today.

DEFICITS ROSE ALONG WITH TAXES

Secretary **Regan**. Well, Senator, could we go back to the previous 4 years before we were here? In each of those years, 1977, 1978, 1979, and 1980, taxes were raised. That is a point of fact; receipts rose. And what rose with it? Deficits. There were more deficits at 3 of those 4 years. Now, what caused that——

Senator **Exon**. And there was more spending.

Secretary **Regan**. Right. That is what I am saying. You have got to cut spending.

Senator **Exon**. We did cut——

Secretary **Regan**. If you keep raising taxes, suppose you raise taxes to 100 percent? What——

Senator **Exon**. You are recommending the largest expenditures in the area of defense in the history of this country. Is not that raising expenditures? You say that is all right. What you are really saying to us is it is all right. You think we——

Secretary **Regan**. Do you think we should not have a good——

Senator **Exon**. An 18-percent increase in defense and you keep telling us that, if you want to, you can balance the budget by cutting food stamps. That is ridiculous.

Secretary **Regan**. That is not what we are saying. We did not say you could balance the budget by cutting food stamps. This administration has never said that.

What I am telling you, Senator, is that there are ways to cut more out of this budget.

Senator **Exon**. I agree with you, including defense. Do you agree with me on that?

BUDGET CANNOT BE BALANCED ON BACKS OF TAXPAYERS

Secretary **Regan**. I will not touch defense. The President of the United States is the Commander in Chief. He has more knowledge about that than I do. I am Secretary of Treasury, not Defense.

As far as what we are saying here about taxes is concerned, I do not believe that you can balance the budget on the backs of the taxpayers. The President has said this over and over again. Now, you may say that is posturing, but what good——

Senator **Exon**. Mr. Secretary, Russell Long said it the other day; it was not my idea but I thought it was a good statement. You just made it. The President said it in his state of the Union address, that we are not going to balance the budget on the back of the American taxpayer.

If we are not going to balance it on the back of the American taxpayer, how are we going to?

Secretary **Regan**. By shrinking the size of the Federal Government.

Senator **Exon**. Are they still going to pay taxes? Or are you going to eliminate all taxes?

Secretary **Regan**. They will not pay higher tax rates. They will pay lower tax rates than they are now.

Senator **Exon**. Mr. Secretary, I must say I am afraid you are in a dream world. I do not think this administration is facing reality. If you went out and talked to the people that I talked to in Nebraska today, they have a major "Concern" with a capital "C" about what is going on in the economy today. I do not think you are facing it realistically. When I get into the main increase in expenditures of this Government on defense, you say you are not going to talk about it.

Secretary **Regan**. May I quote you something, Senator?

Senator **Exon**. Certainly.

Secretary **Regan**. Our true choice is not between tax reductions on one hand and the avoidance of large Federal deficits on the other. An economy hampered by restrictive tax rates will never produce enough revenue to balance the budget, just as it will never produce enough jobs or enough profits.

President John Kennedy said that, sir, in 1962.

Senator **Exon**. Nor, Mr. Secretary, will we ever straighten out our economy with the large deficits that this administration is recommending in the budget that we just received.

My time is up. I yield.

Senator **Kasten**. Senator Biden is next.

Senator **Biden**. I would like to begin with a moment of silence for John Kennedy and F.D.R. You folks spend so much time quoting them. I am so delighted to understand you understand them so well. Every person who has come before this committee has either dug back and quoted John Kennedy or F.D.R. It shows that in your search for quotes you probably have found that there is little to quote from other Republican administrations because you never quote anybody but Democrats.

Secretary **Regan**. Senator, do you ever quote a classmate of yours and a friend of yours? John Kennedy and I were classmates at college. He was a friend of mine.

Senator **Biden**. Well, I am glad. I will exempt you from my mild accusation, but I pass the message on. Apparently, he had about 30 classmates in this administration.

Secretary **Regan**. He had 400 classmates.

Senator **Biden**. I find it fascinating. Anyway, let me get to my questions if I may.

I am trying to think of a quote from Nixon. I cannot think of one. Let's make something perfectly clear. That's a quote. Let's be clear today.

$100 BILLION DEFICIT ACCEPTABLE

Is $100 billion of deficit for 1983 acceptable to you?

Secretary **Regan**. For 1983?

Senator **Biden**. Yes.

Secretary **Regan**. No. We are suggesting it should be in the neighborhood of $90 billion.

Senator **Biden**. So, a $90 billion deficit is acceptable to you?

Secretary **Regan**. Unfortunately, yes.

Senator **Biden**. And an eighty-three-or-so billion dollar deficit in 1984 is acceptable to you? That is what you are projecting, 80-something, right? And what is 1985?

Secretary **Regan**. I think it comes out to about $10 billion per year.

Senator **Biden**. About 72, OK. Now, the thing that I am finding is that, whether you talk about some of your friends who are your friends in my State of Delaware, some of your corporate associates, or whether you are talking to small business people, the thing that frightens them is that deficit, that number. Whether it is 92 or a more realistic number that we think—let us say 92 is realistic. Mr. Stockman acknowledged yesterday if it keeps to 92, even with all the cuts, it will be a real surprise. But, you know, let us say 92.

They are telling me, those business folks out there, that 92 is not acceptable. They do not see how that can happen. They do not see how that can be sustained. You say we should not go at the tax side, and let us leave that alone.

I want to know how we can cut. I want to cut some more spending beyond what you are recommending. Where else can I cut some spending beyond what you have recommended? I want to get at the deficit. Let us cut more spending than you recommended, and let's leave the Defense Department alone. That is what we are going to do, right? I mean, you do not know anything about defense; I do not know anything about defense; only the President does. So, the President's budget on defense is sacrosanct. Where are we going to cut more to do something about the deficit? I want to cut.

PRESIDENT WILLING TO WORK WITH CONGRESS

Secretary REGAN. Senator, I think that what the President has said is what I will stick with here. He has made his proposals as to where the cuts should be, and we know where they are from the budget document. As far as other cuts in other areas, he has said he would be very willing to work with the Congress if you were to come up with some suggestion.

Senator BIDEN. But he does not have any more suggestions, does he?

Secretary REGAN. He has made his suggestions. He thinks that he will probably have more in 1983 and more in 1984. But at the present time he is willing to stick with those.

Senator BIDEN. I just want to make sure that we understand. If in fact everything that is asked for by the President is given to the President again this year, there is no way that we are going to get the deficit, including the spending cuts, below $90 billion. There is no realistic way that is going to happen, is there?

Secretary REGAN. No, not unless we are exceedingly lucky with the economy and it grows at a faster rate and unemployment goes down faster than we projected.

Senator BIDEN. When we talk about additional—you do not, but when some of us around this table on both sides of the aisle talk about additional spending cuts or additional tax revenues, when we talk on the tax side, you say that—you use the phrase that what will happen it will just be the Government spending that money instead of the people spending the money. Do you really think that, if we were able to raise an additional $40 billion in taxes by whatever means, by eliminating or delaying the second year of the tax cut or by any mechanism, do you actually believe—you're an astute fellow—do you actually believe that there is any way this Congress could do anything other than apply that to the deficit for reduction politically?

ADDITIONAL TAX REVENUES WOULD BE SPENT

Do you think there is any possibility that those additional tax revenues would be able to be spent on programmatic changes? Or would not it be that they would have to go to the reduction of that $90 billion figure?

Secretary REGAN. I think that what the Senator would find, were that situation to exist, that there would be many groups up here asking that some of the cuts that have been previously made be restored and therefore the money spent, yes.

Senator BIDEN. So, you actually think it would be spent?

Secretary REGAN. Yes.

Senator BIDEN. That is interesting.

I guess my time is up. There is a lot more I want to ask you about. I will stick around. Thank you very much.

Senator KASTEN. Mr. Secretary, you were talking with Senator Grassley about big business and different kinds of tax changes. If we are going to have to have any kind of revenue increases, they ought not to be the sort that would affect the second or the third year of the tax cut. They ought not to be changes that would affect the basic program we all campaigned on, which included cuts in marginal tax rates and accelerated depreciation. But in the process of trading back and forth in the House of Representatives, we ended up with a number of things that none of us campaigned on but just kind of fell in. One of them was the law permitting trading or leasing of tax benefits. Yesterday you said—maybe it was the day before—that it would be extremely unwise to do so during a recession. You reasoned that ailing industries are taking advantage of leases to raise cash.

I am an author of a bill that would eliminate the safe-harbor leasing provision. We ought to find another way to help these industries who need the leasing provision. I am not sure it should be refundable tax credits. I do not know what it should be. But there is a basic sense of inequity that has come out of this tax leasing provision.

If we are going to raise additional revenues, let us go in the direction of eliminating gross distortions in the code. Let us go and establish a minimum tax on corporations. Let us change some of the things that were, in a way, imposed upon us in the last tax debate rather than having to cave in or compromise on the basic thrust of our program that we all want to keep in place.

Secretary REGAN. Senator, if you recall why the administration proposed leasing in the tax bill last year, this was before the horse trading actually went on. But there were proposals in front of the Ways and Means Committee and in front of the Senate Finance Committee for these refundable tax credits. We felt that that smacked too much of putting certain industries on the Federal dole, as it were. We decided that what we would try to do would be to come up with a different approach to it.

The leasing concept struck us as one where the private sector could benefit legitimately. After all, if a corporation is going to borrow money in order to come up with new machinery and that company is not earning enough money to take advantage of the investment tax credit, it will have to think twice about whether or not it actually will do that. So, if an industry is not making profits, whether it be the steel industry, the mining industry, the timber industry, any other industry, housing in particular, how do you assume that firms in that industry can use these tax credits to its advantage to improve its cash flow. If it is possible, why not let it do it?

If the companies would utilize leasing, why not let it do it?

WAIT BEFORE DRAWING CONCLUSIONS ON LEASING

What I cautioned the Senate Finance Committee on yesterday, and I would again recommend it to this committee, that we not draw conclusions about leasing till we see the study that will come out of the Treasury Department, hopefully, by mid-March. As you recall, we were requested to furnish all the information on leasing to this Congress. We asked anyone that had engaged in leasing to give us a report by January 31. That information is now in.

We are giving high priority to getting this study to the Congress by mid-March. Then we can make up our minds about what has actually happened in the leasing area rather than what we have read in the press or incomplete reports.

Senator KASTEN. I do not think I have to remind you that this is not only an economic decision. It is also a political one. In the political atmosphere this is an idea that has been tried and, frankly, is not very successful. You can provide information showing that leasing is the right economic thing to do—and I agree that we want to help people get back to work in companies that are making a profit. We also want to put people back to work in companies that are not making a profit so that, hopefully, those companies can make a profit in the future.

The people that bought those benefits, such as Occidental Petroleum, are not paying taxes and have created a political problem that, frankly, I am not sure any report is going to solve.

I am concerned that any changes we make in the revenue side apply to the add-ons—the Christmas tree ornaments—in the Economic Recovery Tax Act of 1981, instead of the core of that act.

Secretary REGAN. I understand what the Senator is saying. It makes political sense. I have to remind the Senator that we always promised last year, although there was quite a bit of derision when I made this suggestion, that we would be on a two-track basis; there would be a second tax bill to follow the first. Well, the tracks seem to merge, and we came up with one instead of two. Nonetheless, many of those proposals in the first tax bill—the only tax bill last year—were many that we would have had in the second tax bill.

Senator KASTEN. Thank you, Mr. Chairman.

SENATORS DO NOT ALWAYS KNOW WHAT IS IN A BILL

Chairman DOMENICI. Mr. Secretary, just on that provision of the tax code for a bit, I would submit to you that, in spite of the talk around here which would lead one to believe that Senators at large know what is in bills such as that tax bill, we do not and we did not. For instance, I read with extreme interest that the city of Oakland is selling libraries to the private sector so they can take the loss, and then they lease back the library. In New York, I found out, they are all geared up to bail out their railroad system, their inter-city railroad system via lease-purchase.

Secretary **Regan**. I think they call it up there rent-a-bus.

Chairman **Domenici**. Yes, rent-a-something.

I understand there is a separate provision in the bill for public involvement. I did not know that. I am sure that, until they read it in the paper, that I am probably one of many 70 or 80 Senators that did not know that was in there. I understand that it was a separate provision put in during the deliberations.

I think it is things like that that cause Senator Kasten to be right. We might have something there that ought to be saved, but we ought to be awfully careful in saving it. We ought to do it rather quickly. I know you want to wait. There are some areas, however, that ought to be saved. I think the whole thing is going to go down if the saving is not explained with more clarity about who is going to be using it and for what.

Secretary **Regan**. Senator, if I could comment just for the record. Oakland, I do not believe, in that library sale will be a safe-harbor leasing under the leasing provision of ERTA. I think that comes under a different section of the code.

Second, as far as mass transit is concerned, I think New York City is probably the only one that had the exception in there. Now, it is true that the Senators probably did not understand that, and I get the point that you are making.

ANALYSIS SHOULD BE MADE QUICKLY

Chairman **Domenici**. I think in the months that pass we ought not be waiting around. I think you ought to get it analyzed quickly. Since it has some merit, you ought to get the meritorious things out there as quickly as possible. I think the Senator is absolutely correct. I think that is why Senator Dole said what he said.

Secretary **Regan**. We did have a colloquy yesterday about what the Senator said and what I said.

Chairman **Domenici**. I was told that the county in which I live is doing this with their buses. I do not know under what provision. Maybe it is the old one, not the new one. I would have a nice interest because they buy buses, believe it or not, from New Mexico. I did not know that the increased bus purchases in my State might occur this way.

Senator **Biden**. Could my church get in on this?

Secretary **Regan**. Not unless your church has a bus, I am told. Buses were OK.

Senator **Biden**. They do have buses for senior citizens. We may be able to work something out here. I am getting to like this more as we go on.

Chairman **Domenici**. I have just two questions.

In discussing the Senator Hollings' approach, I do not think you meant to leave the impression that a significant reduction in the deficit by itself would cause the negatives that you have given to his program. It is not just the reduction in deficit.

Secretary **Regan**. It was a method of achieving it.

As I told the Senator, we agree in principle on two things: A, getting the deficit down; and, B, high interest rates are our No. 1 problem. It was just in the method that he had selected.

Chairman DOMENICI. We could get into that. There are only two areas with which we can do anything and that is military and revenues. I hope you are not suggesting that changes in either of those would cause this devastating effect. We will be working with you on that in the future.

ACCELERATION OF TAX INCREASE WOULD NOT HELP

One question about the personal tax cut. What would happen if the tax cut for individuals, which is scheduled to increase in July, were accelerated and the tail end was spread out? Have you run any models on that? What if you accelerated the July cut to January and then took the last 10 percent and made it effective in 1984 and 1985? You would have nothing in 1983 but additional deficit this year. You would be giving the taxpayers an additional tax cut now.

Secretary REGAN. I have asked my associates for a chart similar to the one I showed, I believe, to Senator Chiles in answer to his question. We had figured it out at Treasury. I am not sure we have the chart with us.

Let me just point out to the Senator that time is of such essence here that I doubt if we can at this point, with any degree of assurance that it would have a good effect, speed up that tax increase from July 1, 1982, to January 1, 1982. The reason is a practical one. By the time it would get through the Congress, signed by the President, to the IRS, new withholding tables made up, submitted to industry and then put into effect in payrolls, I am afraid that we would be to the end of May in that time sequence. And they are already prepared to do it the first of July. So, for the 1 month, I do not think it would have that much effect.

As far as delaying it, of course, I am opposed to that. The reason that I am opposed to it is the very fact that $30 to $40 billion would not be coming back into the economy into the private sector in 1983 with what I think would be very harmful effects on savings rates and other effects of that nature in that period.

Chairman DOMENICI. But from the macroeconomic standpoint, it would not have a significant adverse effect if the deficit was increased in 1982 by virtue of accelerated cuts and by spreading them out on the other side?

Secretary REGAN. As I recall the figure, it is somewhere in the neighborhood of $7 billion of revenues that would be lost on a static basis if that tax cut were to go into effect on January 1, 1982, rather than July 1, 1982.

Chairman DOMENICI. But macro-wise, it would not contribute to the recession or inflation?

Secretary REGAN. I would have to say probably not.

BASIC PROPOSALS VERY INTERESTING

Chairman DOMENICI. Mr. Secretary, I know you have not had an opportunity to see my basic proposals. They are not very different from what I suggested last year, as you know. Could you give us at least your general impressions of that proposal?

Secretary **Regan**. Senator, we did a quick review of these—and I did not get to see this until late yesterday afternoon. At Treasury we have had no time to run it through our static models, which obviously I will do as quickly as possible. I find it very interesting. I do not reject it out of hand. I am not terming it in any way, shape, or fashion except to say I would like time to study it to see if it reasonably parallels ours. It does a little bit more as far as the deficit is concerned. It gets at the deficits, though, in a different way than we do. So, I would like to study to see what the effects on the economy would be. Politically, I will not comment on it.

Chairman **Domenici**. Thank you very much. I think Senator Exon wanted a second turn.

Senator **Exon**. Mr. Secretary, we are all concerned about the recovery from this very serious recession. We know that agriculture is in deep trouble and automobiles and other things that maybe you are not directly concerned with. But we are looking and hopeful that the homebuilding and construction industry can begin to lead us out of this.

When we mention that, of course, we think of the difficulties in the thrift institutions today, which is something that you are directly involved in. Could you enlighten the committee on what steps the administration is going to be taking with regard to at least some difficulties with the thrifts today? I saw a story this morning that the White House had indicated that they would not go along with some of the proposals to assist the thrifts that have been introduced. What are your plans in that area, Mr. Secretary?

THRIFT INDUSTRY NEEDS LOWER RATES OF INTEREST

Secretary **Regan**. Obviously, Senator, the main thing that the thrift industry needs is lower rates of interest. Were interest rates lower, their cost of funds would not be that great, and there would be more borrowers around for whatever funds were available. What the industry is doing, obviously, is it is paying more for its money than it is getting back in. The cost of funds is somewhere a little over 12 percent. They are receiving somewhere in the neighborhood of 10 percent on their assets. That 2-percent gap is cutting back on their net worth.

What we have suggested are remedies in two, maybe three, main areas.

First of all, we have suggested to the Federal Home Loan Bank that they can make capital injections into these institutions so that the relationship of their capital to their total assets, to their net worth, does not go down below the safety line, which in some States is 5 percent, others 3 percent. These would be debentures. These debentures would be guaranteed by the Government. They would be capital infusions into these institutions to keep them afloat. To use an analogy, it would be a life preserver just to keep them afloat until such time as interest rates come down, and not allow them to fail.

This has been tried by the Federal Home Loan Bank Board in three cases now: one in New Hampshire, one in Chicago, and one someplace else—I forget where—with success. We say that that lifeline is available and is there.

Second, we are supporting the bill that Senator Garn has introduced called S. 1720, which is a broad-based change in financial institutions. Title I would give many new powers to the thrift institutions, to allow them to go into commercial loans, into mutual funds, into money market funds. These are their competition. These are the competitors to which they are losing funds at this moment.

ADMINISTRATION MIGHT GO BEYOND GARN BILL

Senator EXON. Mr. Secretary, I have heard suggestions that the administration might wish to even go beyond the Garn bill with regard to financial institutions getting into the business of selling insurance, getting into the further business of handling stocks and bonds. What is your attitude and opinion on that?

Secretary REGAN. That is title III of the Garn bill, S. 1720. What it actually does—and this is a proposal of the administration, to change title III somewhat—that we set up separate subsidiaries under a holding company in a bank. These are designed primarily for banks, not for the thrifts as yet. The thrifts could do this later after they get some other intermediate powers. What would happen here would be that you have financial institutions competing with each other in various fields. If an insurance company can compete with a bank, why not allow the bank to compete with the insurance company? If a brokerage firm wishes to get into banking or near banking, why not allow the bank to get into the brokerage industry?

Senator EXON. Why not? Because, at least from my rather limited knowledge of this, it seems to me that, when you run this through the washing machine once, you are going to come out with a wash, where this administration is simply proposing that all financial institutions whether they are now banks or thrift institutions or any combination thereof all become banks, all do about the same thing.

Is that a fair assumption of where we think you are heading with your policy?

Secretary REGAN. No. That does not necessarily have to be. Let me use an analogy, if I might, in the chain store business. It used to be that the housewife had to go to a dry goods grocer, had to go to a butcher, had to go to a fruitstand, would have to go to a hardware store, and the like.

Senator EXON. Drugstore——

Secretary REGAN. Drugstore and the like. Now she can go to one, or she can go to each of those individuals. There are still hardware stores. There still are butcher shops. There still are other types of specialty stores. That gives the consumer the choice.

PLAN WOULD ALLOW PEOPLE CHOICE

Now, we are not saying that all banks would have to do this or all brokerage firms would have to do this. The choice is theirs whether they wish to get into any of these other things or not. A chain store does not have to sell drugs. It may if it so desires. A drugstore does not have to sell hardware items. The choice is theirs.

Senator EXON. But it is true, though, that your plan basically would on the bottom line allow any of these people to go into these other businesses if they so desired?

Secretary REGAN. As long as they are regulated equally and as long as the competition is fair, yes.

Senator EXON. The end result of this might be, might it not, that we would see a higher and higher concentration of the control of our money into fewer and fewer hands?

Secretary REGAN. No, I do not think that necessarily follows, either, Senator, for the simple reason that you have concentrations now of power among large insurance companies, large banks, and the like. But you have an awful lot of smaller institutions in the same business. I think the same thing would happen. I do not think the concentration ratios would change. It is the same-shaped curve no matter where you go. A few of anything control most of whatever it is you are talking about.

Senator EXON. Thank you, Mr. Chairman.

Senator KASTEN. Thank you, Senator Exon.

Mr. Secretary, we will keep the record open on this hearing for 1 week to allow Senators to submit questions in writing. We would hope that you would respond to those questions in a timely fashion, as we have asked Mr. Stockman and others to do the same.

On behalf of the Chairman——

Secretary REGAN. Senator, could I say one other thing for the record?

Senator KASTEN. Yes.

Secretary REGAN. I gave some top-of-the-head answers to some of the questions that these gentlemen asked me. In looking over the record, I would like, if there are corrections, to bring it to the attention of the person who asked the question and also to correct the record.

Senator KASTEN. Without objection, you certainly will be able to come back and work with some of the answers and especially some of the statistics that you have quoted today.

Thank you for appearing before us this morning. We look forward to working with you during the difficult few months ahead.

Secretary REGAN. Thank you. I do, too.

Senator KASTEN. The committee is adjourned.

[Whereupon, at 12:35 p.m., the meeting was adjourned.]

VIEWS OF OUTSIDE ECONOMISTS

MONDAY, MARCH 1, 1982

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met at 10:04 a.m., in room 6202, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman) presiding.

Present: Senators Domenici, Boschwitz, Kasten, Gorton, Hollings, Johnston, Moynihan, and Exon.

Staff present: Stephen Bell, staff director; Robert Fulton, chief counsel; Gail Fosler, chief economist; Lizabeth Tankersley, minority staff director; and Kemble Stokes, chief economist.

Chairman DOMENICI. The committee will come to order.

We understand that a number of Senators will arrive. We are going to get started and, as they arrive, they will have their turn to make statements and inquire.

I have a rather brief opening statement I would like to quickly read, and Senator Hollings can then proceed. Under our rules, it will be 5 minutes for each of us when it is our turn, but all three of you will testify first. If any Senators want to interrupt, they may since we do not have a formal approach. As long as it is not dragging, we will yield as you testify.

OPENING STATEMENT OF CHAIRMAN DOMENICI

I am pleased to have the three of you here. I am particularly grateful to Dr. Galbraith who flew here from Finland and has interrupted a trip to India just to be with us this morning.

ECONOMY IN STATE OF EXTRAORDINARY TRANSITION

I cannot emphasize to you too strongly that I believe that we are meeting at a serious juncture in our economic history. The economy is in a state of extraordinary transition. Over the past decade, we have struggled with the transition from cheap energy to high-cost energy. Now, we are trying to cope with the transition from cheap business capital to much more expensive capital. Similarly, we are transferring resources from mature industries to new technologies and from private consumption to private investment in plant and machines and public investment in our national defense.

This economy of ours is a wonder. It is strong, vital, and, in fact, unique in the world's history for its resources and its productive potential. However, it has limits and I believe that we are now at the point of testing these limits. The economy is fragile and we must neither underestimate or overestimate the good or evil that we are capable of causing. As Karl Jung, the psychologist, once said, "We must not attempt to do good until we truly know the evil of which we are capable." This is true now as never before of the economic policymaking process in this Nation.

Gentlemen, to be clear, it is absolutely necessary for this committee to understand the reality of the economic decisions that we face. We must brush aside all of the political rhetoric and assess, straight on, realistic economic goals for ourselves.

CONGRESS WILL DETERMINE COURSE OF ECONOMY

The decisions that we in the Congress make over the next few weeks—and I mean weeks, not months—will determine the course of the economy over the next several years as well as the economic role of the United States in a world that is very different from the past. It is a world which is enormously fragmented both politically and economically and in which the United States no longer dominates economically or militarily.

I hope your testimony this morning will provide for us a better understanding of the problems that we face and the possible limits to our success despite our best economic policy efforts. I am particularly interested in structural changes in the economy and what appears to me to be massive transfers of resources from one sector to another.

I also hope that you will discuss with us the economic policy choices that we face in the context of these structural changes, and will provide us with guidance on how we should begin to make the very important budget decisions we face in the coming weeks.

I yield to my good friend, Senator Hollings.

Senator HOLLINGS. Thank you, Mr. Chairman.

Let me yield to our distinguished colleague, Senator Moynihan. He would like to welcome his constituents.

OPENING STATEMENT OF SENATOR MOYNIHAN

Senator MOYNIHAN. Mr. Chairman, you are very generous. I will indeed welcome my two former colleagues, Dr. Galbraith and Dr. Eckstein, and my Chairman on the Social Security Commission, Dr. Greenspan. It is catalystic for these gentlemen to cross the Atlantic, if need be, to advise us. Before turning to their advice, I would like to call our attention once again to your observation about the limits of our knowledge and of our capacities to understand and control some of the events that we are expressing. We have endured a year in which one encountered many confident people who reminded you of Melbourne's observation about his colleague. He once said, "I wish I was as sure about anything as McCauley is about everything."

These are men, however, who know that economics is not simple, that government is not simple, and that there is no free lunch. They shall also know that they are more than welcome in this chamber, which is turning itself to their issues—not the least because of your leadership.

Chairman DOMENICI. Dr. Galbraith, you may proceed.

STATEMENT OF JOHN KENNETH GALBRAITH, PAUL M. WARBURG PROFESSOR OF ECONOMICS EMERITUS, HARVARD UNIVERSITY

Dr. GALBRAITH. Mr. Chairman, when I came to address this subject, I found that I had rather more to say than there would be time for this morning.

I wonder if, with your permission, I might give you the whole paper I prepared, and in courtesy to my two colleagues I will read some parts of what I have written and summarize the rest.

Chairman DOMENICI. Dr. Galbraith, your entire statement will be made a part of the record and you can proceed as you see fit.

BUDGET CONSEQUENCES

Dr. GALBRAITH. Thank you very much.

Mr. Chairman, the budget that you are considering raises problems that go well beyond ideological or partisan preferences. It raises questions for liberals and conservatives, Republicans and Democrats alike. I am not a wholehearted supporter of the administration, but it is not my purpose this morning to score points against it, an avocation that I have enjoyed on occasion in the past. The matter is too serious. I would like, rather, to address the all but certain effects of the budget as it now stands and then proceed to the appropriate remedial action—what needs to be done.

On the consequences of the budget, I find myself in harmony with the great majority of other economists and the instincts of the American people at large. Indeed, for the first time in my professional life, stretching now over half a century, there is a broad unity of view extending from the conservative economists of the American Enterprise Institute to Wall Street to my liberal coreligionists. All manifest a deeply concerned opposition to the economic design being offered for the year 1983 and thereafter. The opposition extends in everything but official expression to numerous economists and economic officials within the administration. I venture to believe that were Mr. Donald Regan back in Wall Street, he would share the grave doubts that his distinguished firm and colleagues now express and according to which they advise their clients. Similarly, Mr. Murray Weidenbaum. Were he back at Washington University in St. Louis where he served so long and with so much distinction, he would not conceal his deeper belief. Economics and economic policy are a flexible discipline; they allow those in office a considerable latitude in stated belief. One wonders if the budget you are considering has not required more subordination of professional conviction to political loyalty and the pleasures of public office than any public official can rightly defend.

LARGE DEFICITS UNWISE AND DANGEROUS

The surface concern is with the deficits that are being projected—$91.5 billion in 1983, almost equally massive figures for the years following. This concern has been deepened by the imaginative fudging of the figures to get the deficit down to the stated levels, the certainty, as James Schlesinger and others have competently told, that the gap between revenues and real expenditures will be much greater. Indeed, as I will later urge, if inflation is to be curbed, the economic policy—the reliance on monetary policy—insures that the deficit will be greater. It is the sound instinct of the American people that deficits in this magnitude are unwise and dangerous. Nor do I believe that people accept as a defense that all budget problems—indeed, all economic problems—are the inheritance of previous Democratic and Republican administrations. This, what may be called the archeological alibi, must never be taken seriously. All administrations of whatever political color must be held firmly responsible for what happens in their own time; otherwise one day we will have some imaginative economist attributing his failures to the erroneous economic framework established by Alexander Hamilton.

But the problem of the deficit lies deeper. It is not in the fact that more money is spent than received but in the constraints and contradictions that this imposes on other economic policy.

COUNTERING LINES OF POLICY

Specifically in an economy with a strong commitment to inflation—one in which pressure on the price level is, as now, a continuing and persistent force—there are only three countering lines of policy. One is direct restraint on wages and prices in the highly organized sector of the economy—not small business but the area of large corporations and unions. This the administration eschews. The second is restraint on inflation through the budget; this the prospective deficit denies; as one cannot sink and swim at the same time, so one cannot have a large budget deficit and fiscal restraint at the same time.

MONETARY POLICY WORKS AGAINST INFLATION

It was Calvin Coolidge who enunciated a similar truth when he said, "When many people are out of work, unemployment results." So also one cannot have a large budget deficit and fiscal restraints at the same time. There remains therefore only monetary policy as an agent against inflation. Prayer aside, it is the only recourse. That a flaccid fiscal policy places the burden on monetary policy the administration does not deny. It so affirms. This year's "Economic Report of the President" says flatly that a "deficit financed by money creation will have persistent inflationary consequences." These inflationary consequences, it follows, can only be avoided by a firm refusal of the Federal Reserve to allow such money creation, in short, by a rigorously stern monetary policy.

Here we encounter the first of the contradictions. Control of the money supply, the essence of monetary policy, is far more difficult than once imagined by its advocates. But if the effort is sufficiently pressed, it will work, is working now. The question is the cost. There is no mystery as to how monetary policy works against inflation. It works by restraining bank lending and resulting bank deposit and other money creation and the spending therefrom. It does this primarily through high interest rates. These put the price of credit beyond the reach of would-be borrowers. And it denies credit to those firms and industries which habitually depend on bank and other borrowing to do business. From the constraint imposed on lending come reduced spending for capital and consumer's goods, a recession in economic activity and, if not lower prices, at least a lessened rate of inflation. That has been the effect of the policy in these last months. The recession we now experience was not an adventitious or accidental thing. It was the scheduled result of the policy we are using against inflation; it is through a recession such as we are now experiencing that monetary policy works.

MONETARY POLICY SHOULD DENY OUTPUT EXPANSION

There is a further contradiction in the budget prospect that will now be obvious. The budget deficit as now projected assumes an expansion in real output in calendar 1983 of 5.8 percent. But if inflation is to be controlled, the monetary policy will have to be sufficiently restrictive so as to deny any considerable expansion in output. Perhaps, as in these last months, it will require a contraction in output. Inflation is not a one-time thing that, once extruded from the system, is like some poison gone for good. The effect of the restrictive money policy that the deficit requires will, in turn, cut down on tax revenues, increase payments under the various entitlement programs, and thus increase the deficit. There is nothing hypothetical about this prospect. It is precisely what has happened in Britain as the British Government has followed similar budget policies with a similar reliance on monetary policy. Economics is not a compassionate thing. It does not deal gently with those who pursue such basically contradictory policies—who look for expanding revenues and diminishing expenditures from a policy that succeeds by economic contraction, reduced public revenues, and higher claims on the budget.

CREDIT-SENSITIVE INDUSTRIES AFFECTED BY MONETARY POLICY

A recession so brought about by a deficit and the reliance on monetary policy has a restraining effect on spending in general and thus on prices. But monetary policy has also a more specific effect on those industries that are particularly dependent on borrowed money—what are coming to be called the credit-sensitive industries. Thus it works generally on the automobile industry by cutting back on purchases of automobiles. But it has a more specific effect by cutting back, through high interest rates, on lending for the purchase of cars. And it affects this industry also by raising the cost of credit to dealers and thus the cost of carrying inventory with the further effect of putting some out of business. From all of this comes the anti-inflationary effect—price rebates by the automobile companies, wage and other concessions from the unions—which we read about so much in the paper today. These effects we shall continue to have so long as we are forced by deficit financing to rely on monetary policy, for that, to repeat, is the way it works.

There is a similar selective effect on the other credit-sensitive industries. Reduced demand from the recession acts against farm prices in general. But the high interest rates also force farmers to suspend purchases of farm machinery with highly visible effects on the farm equipment industry, notably on International Harvester. The policy similarly singles out the housing industry, construction in general and the real estate business, with consequences all can see. Here, too, as all know, there is extensive reliance on borrowed money, hence exceptional vulnerability to monetary policy. The selective effects of monetary policy and high interest rates extend to small business in general, where the failure rate last year reached the highest level in 20 years, and the highest, one year excepted, since the Great Depression. This is the way monetary policy is working and is meant to work. These are the consequences we must expect if budget deficits require a continued reliance on monetary policy as the alternative to severe inflation. I might, Mr. Chairman, allow myself one political comment.

We have heard much from liberals and the trade unions of the effect of monetary policy on employment—of the social cruelty of a policy that works by making unemployment the restraininq influence on wages and which at the most optimistic promises unemployment in the range of 8 or 9 percent of the labor force. But I would draw particular attention to the effects of the policy on car dealers, homebuilders, construction firms, merchants, and farmers. They have often been called the backbone of the Republican Party. They are the people of Main Street. No one can accuse this administration of sparing its own.

This is the policy and punishment which, in the absence of any fiscal restraint, will have to be continued and intensified in the months ahead—the policy that is made necessary, always assuming that inflation is to be contained, by the deficits. If the monetary restraint is relaxed, there will be inflation. There are three further consequences with which we must be concerned.

Mr. Chairman, how am I doing on my time?

Chairman DOMENICI. Another 5 minutes.

HIGH INTEREST RATES SQUELCH BORROWING FOR INVESTMENT

Dr. GALBRAITH. Good. I will summarize several pages here, Mr. Chairman.

It is from borrowing for investment that we get improvement in productivity but high interest rates squelch that borrowing. An economy that is running close to capacity also stimulates investments. But when monetary policy is used to suppress inflation, it has the effect of reducing investments, thus minimizing productivity gains. There should be no mystery as to why we had a low productivity rate in this country the last few years. It is the counterpart of our current monetary policy. There are also from this policy, Mr. Chairman, some very disagreeable international effects. Our high interest rates are exported to the European countries and in defense they are forced to raise their interest rates.

We have had in these last weeks strong complaints from the British Chancellor of the Exchequer, the German Chancellor, the head of the Bundesbank in Germany, the President of France, the Belgian Prime Minister, and the Prime Minister of Canada. They have all expressed themselves on the deficits in our budget, the interest rate policies and the consequent effects on their countries. We have done a great deal in these last weeks to promote unity among our allies.

There is no comparison between the deficits induced by the tax reductions in this budget and those in the past. There has been a lot of reference to the Kennedy-Johnson tax cuts in the early sixties. That was at a time when interest rates were at nominal levels and being reduced, and when there was therefore no tradeoff as between the deficits and a strong monetary policy.

I might say as a personal matter I opposed the tax reduction even at that time.

Turning now, Mr. Chairman, in the 3 or 4 minutes that remain, to what should be done, I would like to make essentially three points which, in discussion, we can perhaps go into in more detail.

UNEASY ABOUT FURTHER CUTS IN SOCIAL BUDGET

I am uneasy, as I hope everyone is, about further reductions in the social budget, in the entitlement program. We have already had large reductions in here, and they have not worked themselves through the system. I would be very much afraid of further massive cuts in that area.

I point out in my testimony that social tranquility in our cities is not less important for conservatives than for liberals.

SUBSTANTIAL OPPORTUNITY FOR CUTS IN MILITARY BUDGET

I deal at some length in my statement with the military budget. I do believe that there is substantial opportunity for cuts there, and I would like to bring that urgently to the attention of the committee.

All know the factors that determine the scale of the military budget: military needs, natural bureaucratic interests, what serves the competition between the armed services, the massive economic interest of the weapons firms, and finally political fear. In this day and age, motherhood can be criticized but mention of Russia, and the bravest men take, politically speaking, to the hills.

I suggest at some length the way in which our military budget through the seventies used up capital which in Germany and Japan was available for civilian industries. This has been an important sacrifice to our political and economic leadership in the world, and it raises the question whether the further military increases will not mean a further sacrifice. It is a poor trade to exchange our industrial eminence for relatively sterile military leadership in an age of substantial overkill.

I would like, had time permitted, to go into some detail on the items in the military budget. I hope that there may be a chance to come back to that in the discussion, Mr. Chairman.

TAX REDUCTIONS

I am very uneasy about the income tax reductions that are in prospect. I would strongly urge upon the Congress that both the tax reduction coming this summer and the one a year from now be postponed with some possibility of relief in the low-income brackets. I would urge closing of the loopholes in the corporation income tax—we have advertisements now which blandly say that any firm paying a corporation income tax has not mastered the loopholes that have been made available to it. I would like to see a windfall tax on gains from oil and gas deregulation. This has been very much discussed. And I would like to see a very careful and skeptical consideration of the talk of the New Federalism. We must bear in mind, Mr. Chairman, that there is a basic flaw in the American fiscal system which gives the revenues to the Federal Government, one of the best financed units of government anywhere in the world, and gives the problems to our States and cities. The money goes one way and the problems go another. Therefore, a reallocation of revenues from the Federal Government to the States and localities is not an act of generosity. It is a correction of a basic fiscal flaw in our system.

NEW FEDERALISM

I might say a few concluding words.

Mr. Stockman, with admirable candor, said last year that the concept of supply-side economics and its associated rhetoric were a cover for the reduction of income taxes, the perceptible gain again being in the upper brackets. That conservatives should seek a reduction in the upper-income tax brackets is not remarkable; not less than liberals, conservatives have their constituency. What is not forgivable is that conservatives should disguise their purposes behind supply-side rhetoric or that of a New Federalism. Plain speech is proper to people of all political faiths.

Conservatives especially should not accept the deficit in its prospective magnitude. There is room for ideological difference on how public sevices should be financed; there is no room for difference on the question of whether or not they should be financed. Deficits on the scale now projected effectively remove all freedom of economic action and commit the Government to a monetary policy that we have already learned—as the British have learned—is painfully represssive and potentially disastrous.

I chose those words with some care. It is easy to exaggerate on these matters. I have no wish to do so.

Thank you very much.

Chairman Domenici. Thank you very much, doctor.

PREPARED STATEMENT OF JOHN KENNETH GALBRAITH, PAUL M. WARBURG PROFESSOR OF ECONOMICS EMERITUS, HARVARD UNIVERSITY

Mr. Chairman,

The budget you are considering raises problems that go well beyond ideological or partisan preferences. It raises questions for liberals and conservatives, Republicans and Democrats alike. I am not a supporter of the Administration, but it is not my purpose this morning to score points against it, an avocation that I have enjoyed on occasion in the past. The matter is too serious. I would like, rather, to address the all but certain effects of the budget as it now stands and then proceed to the appropriate remedial action -- what needs to be done.

On the consequences of the budget I find myself in harmony with the great majority of other economists and the instincts of the American people at large. Indeed, for the first time in my professional life, stretching now over half a century, there is a broad unity of view extending from the conservative economists of the American Enterprise Institute to Wall Street to my liberal co-religionists. All manifest a deeply concerned opposition to the economic design being offered for the years 1983 and thereafter. The opposition extends in everything but official expression to numerous economists and economic officials within the Administration. I venture to believe that were Mr. Donald Regan back in Wall Street he would share the grave doubts that his distinguished firm and colleagues now express and according to which they advise their clients. Similarly Mr. Murray Weidenbaum. Were he back at Washington University in St. Louis where he served so long and with so much distinction he would not conceal his deeper belief. Economics and economic policy are a flexible discipline; they allow those in office a considerable latitude in stated belief. One wonders if the budget you are considering hasn't required more subordination of professional conviction to political loyalty and the pleasures of public office than any public official can rightly defend.

The surface concern is with the deficits that are being projected -- $91.5 billion in 1983, almost equally massive figures for the years following. This concern has been deepened by the imaginative fudging of the figures to get the deficit down to the stated levels, the certainty, as James Schlesinger and others have competently told, that the gap between revenues and real expenditures will be much greater. Indeed, as I will later urge, if inflation is to be curbed, the economic policy -- the reliance on monetary policy -- insures it. It is the sound instinct of the American people that deficits in this magnitude are unwise and dangerous. Nor do I believe that people accept as a defense that all budget problems -- indeed, all economic problems -- are the inheritance of previous Democratic and Republican Administrations. This, what may be called the archeological alibi, must never be taken seriously. All administrations of whatever political color must be held firmly responsible for what happens in their own time; otherwise one day we will have some imaginative economist attributing his failures to the erroneous economic framework established by Alexander Hamilton.

But the problem of the deficit lies deeper; it is not in the fact that more money is spent than received but in the constraints and contradictions that this imposes on other economic policy.

Specifically, in an economy with a strong commitment to inflation -- one in which pressure on the price level is, as now, a continuing and persistent force -- there are only three countering lines of policy. One is direct restraint on wages and prices in the highly organized sector of the economy. This the Administration eschews. The second is restraint on inflation through the budget; this the prospective deficit denies; as one cannot sink and swim at the same time, so one cannot have a large budget deficit and fiscal restraint at the same time.

There remains only monetary policy as an agent against inflation. Prayer aside, it is the only recourse. That a flaccid fiscal policy places the burden on monetary policy the Administration does not deny. It so affirms. This year's Economic Report of the President says flatly that a "deficit financed by money creation will have persistent inflationary consequences." These inflationary consequences, it follows, can only be avoided by a firm refusal of the Federal Reserve to allow such money creation, in short by rigorously stern monetary policy.

Here we encounter the first of the contradictions. Control of the money supply, the essence of monetary policy, is far more difficult than once imagined by its advocates. But if the effort is sufficiently pressed, it will work, is working now. The question is the cost. There is no mystery as to how monetary policy works against inflation. It works by restraining bank lending and resulting bank deposit and other money creation and the spending therefrom. It does this primarily through high interest rates; these put the price of credit beyond the reach of would-be borrowers.

And it denies credit to those firms and industries which habitually depend on bank and other borrowing to do business. From the constraint imposed on lending come reduced spending for capital and consumer's goods, a recession in economic activity and, if not lower prices, at least a lessened rate of inflation. That has been the effect of the policy in these last months. The recession we now experience was not an adventitious or accidental thing. It was the scheduled result of the policy we are using against inflation; it is through a recession such as we are now experiencing that monetary policy works.

There is a further contradiction in the budget prospect that will now be obvious. The budget deficit as now projected assumes an expansion in real output in calendar 1983 of 5.8 per cent. But if inflation is to be controlled, the monetary policy will have to be sufficiently restrictive so as to deny any considerable expansion in output. Perhaps, as in these last months, it will require a contraction in output. (Inflation is not a one-time thing that, once extruded from the system, is like some poison gone for good.) The effect of the restrictive money policy that the deficit requires will, in turn, cut down on tax revenues, increase payments under the various entitlement programs and thus increase the deficit. There in nothing hypothetical about this prospect. It is precisely what has happened in Britain as the British government has followed similar budget policies with a similar reliance on monetary policy. Economics is not a compassionate thing. It does not deal gently with those who pursue such basically contradictory policies -- who look for expanding revenues and diminishing expenditures from a policy that succeeds by economic contraction, reduced public revenues and higher claims on the budget.

A recession has a restraining effect on spending in general and thus on prices. But monetary policy has also a more specific effect on those industries that are particularly dependent on borrowed money -- what are coming to be called the credit-sensitive industries. Thus it works generally on the automobile industry by cutting back on purchases of automobiles. But it has a more specific effect by cutting back through high interest rates on lending for the purchase of cars. And it affects this industry also by raising the cost of credit to dealers and thus the cost of carrying inventory, with the further effect of putting some out of business. From all of this comes the anti-inflationary effect -- price rebates by the automobile companies, wage and other concessions from the unions. These effects we shall continue to have so long as we are forced by deficit financing to rely on monetary policy, for that, to repeat, is the way it works.

There is a similar selective effect on the other credit-sensitive industries. Reduced demand from the recession acts against farm prices in general. But the high interest rates also force farmers to suspend purchases of farm machinery with highly visible effects on the farm equipment industry, notably on International Harvester. The policy similarly singles out the housing industry, construction in general and the real estate business with consequences all can see. Here too, as all know, there is extensive reliance on borrowed money, hence exceptional vulnerability to monetary policy. The selective effects of monetary policy and high interest rates extend to small business in general, where the failure rate last year reached the highest level in twenty years and the highest, one year excepted, since the Great Depression.[*]

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[*] It reached a rate of 62 per 10,000 enterprises in April and May of last year, the highest, except for 1961, since the depression years. Economic Report of The President, 1982.

This is the way monetary policy is working and is meant to work. These are the consequences we must expect if budget deficits require a continued reliance on monetary policy as the alternative to severe inflation. I allow myself one political comment.

We have heard much from liberals and the trade unions of the effect of monetary policy on employment -- of the social cruelty of a policy that works by making unemployment the restraining influence on wages and which at the most optimistic promises unemployment in the range of eight or nine per cent of the labor force. (It would, as I hope my union friends will agree, be much less painful to have a direct restraint on wages rather than an indirect restraint operating in the sanguinary fashion of the present monetary policy.) But I would draw particular attention to the effects of the policy on car dealers, home builders, construction firms, merchants and farmers. This is small business; most small businessmen are Republicans. They have often been called the backbone of the Party. They are the people of Main Street. No one can accuse this Administration of sparing its own.

This is the policy and punishment which, in the absence of any fiscal restraint, will have to be continued and intensified in the months ahead -- the policy that is made necessary, always assuming that inflation is to be contained, by the deficits. If the monetary restraint is relaxed, there will be inflation. There are three further consequences with which we must be concerned.

It is from borrowing for investment that we get improvement in productivity. High interest rates squelch such investment, especially that by smaller enterprises. And the recession by which monetary policy suppresses inflation has also an adverse effect on productivity. It is when business is expanding and firms are operating at or near capacity that new plant is wanted, new investment made. New plant is almost always more efficient than the old. The years of high interest rates have, in virtually all countries, been years of low productivity gains. There is no mystery as to why this should be so.

A continuation of the monetary policy that the prospective large deficits will require will also have a deeply damaging effect on the international financial system. The high interest rates that this policy requires draw funds from the other industrial countries. In defense they are forced to raise their interest rates. In such fashion we export our economic policy — including the associated unemployment and recession -- to our friends abroad. This is no hypothetical prospect: in the last weeks the British Chancellor of the Exchequer, the German Chancellor, the head of the Bundesbank in Germany, the President of France, the Belgian Prime Minister and the Prime Minister of Canada have all expressed deep concern verging on anguish over our policy. Rarely have we promoted such unity. If our policy continues, the European countries, acting through European monetary arrangements now in place, will be strongly tempted to control capital outflows and therewith to lower their interest rates and thus to get control over their own policy. Not many European leaders wish to see the world economic system broken in two; there are many who would accept it as an alternative to the disastrous policies that Washington fiscal policy is otherwise forcing upon them.

Finally the deficits now in prospect and the countering monetary action make nonsense of the talk of a supply-side economics ---of a vigorous expansion in the economy unleashed by the tax cuts. This was always an exceptionally dubious design. But not even the most ardent advocates, men who have shown that they will believe anything, can suppose that there can be a vigorous supply-side expansion in combination with tight monetary restraint to control inflation. Those who so suggest, were they doctors, would tell an obese patient with a large appetite that he had only to eat a great deal more in order to grow thin. It is an economics which is guided not by what is right but by what people looking for a painless life like to hear.

Let it be noted that it is no case for the present budget and its revenue shortfall that goverments deliberately resorted to deficit-financing in the past. We have never done so when inflation was a major preoccupation and when monetary policy was being actively used to contain it. The deficit-financing of the depression era was undertaken when prices were falling and interest rates were at all-but-nominal levels. The massive deflationary tendencies of the time allowed of and indeed required both an easier monetary policy and an expansive fiscal policy. No lesson from that period is applicable to a time when inflation is a central concern, when fiscal irresponsibility enhances the emphasis on monetary policy.

The case of the Kennedy-Johnson tax reductions is also cited. That also was a time of nearly stable prices and of low interest rates. With the tax reduction at that time also went pressure on the Federal Reserve to lower interest rates. Again the major difference in controlling circumstances. And I might add, as a personal note, that I opposed the tax reduction at that time. I accorded a higher priority to the expansive effect of needed social programs; I thought and urged that the tax reduction might well set a precedent for unwise future fiscal action.

Let me now turn to remedies -- to what needs to be done. I shall pass over the proposed cuts in social and other civilian expenditures. You have heard much testimony on this and on the consequences. This expenditure, much of it on behalf of the poorest of our people, is not wasteful, dishonest or out of control. Rather, it is the expression of compassion and concern that all modern industrial states have manifested for the poorest or least protected of their citizens. Our expenditures for this purpose have not in relative terms been high; in relation to Gross National Product they have been lower than those of the other major industrial countries with the exception of Japan. It is such expenditure that has tempered the rough edges of the economic system and helped insure its survival. Social tranquility is not less important for conservatives than for liberals. It serves all.

The military budget does call for comment and action. All know of the factors that determine its scale; some of them have nothing to do with defense. To the calculation of military need is added natural bureaucratic interest* and what serves the competition between the services and what serves, often at military cost, the technical dynamic of gadgetry -- the belief that whatever is technically more arcane is always better. To this is added the massive economic interest by the weapons firms that no one denies. Further and finally there is the protection that comes from political fear. In this day and age motherhood can be criticized; but mention Russia and the bravest men take, politically speaking, to the hills.

There is a question as to whether military expenditures at their present and projected levels add to our national strength. The history on this matter is persuasive. During the 1970s we spent, in round figures, a hundred billion dollars annually on the defense establishment, for a total for the decade of roughly a thousand billion (in constant 1976 dollars). Capital in this magnitude could be used for arms; it could be used for private capital investment; it could not be used for both. If an appreciable part of this outlay had gone into the improvement of our industrial plant -- as it would have gone had it not been requisitioned by the government -- no one whatever can doubt that the American economy would be stronger today. And from this stronger economic position would have come, in turn, the economic primacy and political prestige that were enjoyed in the early years following World War II. It was economic, not military, strength on which American world position then depended.

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*On the bureaucratic tendency in the Department of Defense see the testimony of Admiral H. G. Rickover before the Joint Economic Committee, January 28 of this year. One has difficulty imagining a better qualified or more experienced witness.

There is striking empirical evidence of the industrial effect of the arms race. In modern times the American competitive position has declined specifically in relation to that of Germany and Japan. We are not, it is generally believed, less intelligent than the Germans or Japanese. The American raw material and energy base is not less good -- indeed, it is far better. Germany, like the United States, is a mature industrial country, one of old firms and old industries. As I earlier observed, she spends more per capita on social services than does the United States; the Japanese do not spend greatly less. The difference is that the Germans and Japanese have been using their capital to replace old civilian plant and build new and better plant. The United States has been using much more of its capital for industrially limited or sterile military purposes. I here recur to figures I have previously cited.*

Through the decade of the seventies the United States used from five to eight per cent of its Gross National Product for military purposes. The Germans during this decade used between three and four per cent -- in most years relatively about half as much. The Japanese in these ten years devoted less than one per cent of their Gross National Product annually to military use. In 1977, a fairly typical year, American military spending was $441 per capita; that of Germany was $252 per capita; the Japanese spent a mere $47 per capita.

It was from the capital so saved and invested that a substantial share of the civilian investment came which brought these countries to the industrial eminence that now challenges so successfully our own. Again the figures are striking. Through the decade of the seventies our investment in fixed nonmilitary and nonresidential investment ranged from 16.9 per cent of Gross National Product to 19.0 per cent. That of Germany began where ours reached its peak; it ranged upward from 20.6 to 26.7 per cent of Gross National Product. The Japanese range in these years was yet greater -- from 31.0 per cent to a towering 36.6 per cent.* The investment in improvement of civilian plant was broadly the reciprocal of what went for weapons. No one looking at these figures can suppose that our military spending has been a source of industrial and economic strength. Or doubt that it has been at cost to our industrial eminence and to the prestige and influence that go therewith. Certainly no one looking at these figures from the past can view the projected increases in the military budget with equanimity. The Administration itself affirms in the _Economic Report of the President_ that they will be at cost to private capital formation. Is it really sensible to sacrifice our industrial eminence to a military budget that comprises so many elements so slightly related to any valid national concept of security? Lurking at the back of much past defense calculation has been the notion that we could somehow spend the Soviet Union into submission. It is a thought we can no longer tolerate, if, indeed, we ever could.

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* "The Economics of the Arms Race — and After," Bulletin of the Atomic Scientists, June/July, 1981.

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*Figures are from the _Statistical Abstract of the United States_ and _International Economic Indicators_, December 1980.

So, by all means, let us freeze the military budget along the lines proposed by Senator Hollings and then let us have a serious look for savings -- a look at the rehabilitation of those two old battleships, museumpieces both; and at the B-1 bomber with its four or five years of useful survival; and at aircraft carriers that in modern conflict would have to be rushed to the nearest harbor and might not make it; and at the massive overkill in the strategic forces. And let there be serious pressure for an arms control agreement. (The issues here, needless to say, go beyond economics to survival.) The military budget has a highly leveraged relationship to the civilian budget -- a modest reduction in marginal military gadgetry frees a large number of dollars for civilian need or for covering the deficit. Let us in the year ahead use this leverage to the full.

However vigorous and sustained the movement on the military budget, the deficit or some of it will remain. That means taxes must be raised. Let there be no flinching at this prospect; let there be no doubt on one basic and indispensable point. Higher taxes are far better for the economy than higher interest rates. Investment, productivity, economic growth are consistent or can be made consistent with higher taxes. They cannot be reconciled with the high interest rates which, we have sufficiently seen, are the alternative.

There are some obvious possibilities for closing the budget gap on which I will not dwell. There should be prompt repeal of the corporate tax concessions, including the transfer of tax credits. I would also make a strong case for the windfall tax on gains from oil and gas deregulation.

But the obvious and practical action is to defer the tax reductions scheduled for this coming summer and for a year hence. Nothing would have a more immediate and positive effect. There would be a prompt rally in the stock market. Interest rates would fall and bond prices would rise. Economic activity in the credit-sensitive industries would respond. I am never sanguine about economic predictions, including, and perhaps especially, my own. This one I make with a confidence that would be widely shared.

I urge two final points: Let us be very careful about any action, however disguised by rhetoric, which praises local responsibility or a New Federalism and which transfers the costs of government to state and especially to local governments. All public action must take account of and be consonant with one of the major feature one can say flaws, of the American fiscal system. The government of the United States with its access to diverse tax sources and the tendency of its revenue sources to keep abreast of inflation, is by nature one of the best-financed units of government anywhere in the world. And, over the last half-century, nothing has been so persistently evident and so grievously underestimated as the costs of operating the modern large city at any tolerable level of safety, decency and compassion. When people live in close juxtaposition, the costs of government go up exponentially. And they go up on a tax base that, unlike the taxable resources of the federal government, is circumscribed. We have already had a major shift in fiscal responsibility from the best-financed unit of our system of government to the ones in the greatest inherent difficulty. In the last budget there were severe cutbacks in the services to the central cities, services that reflect an effort to correct the disparity berween the fiscal resources of the federal government and those of states and especially cities. It is a path on which, I would urge, we proceed no farther. So to proceed will not strengthen local governments; it will weaken them. And we will cause governors and mayors of whatever party to see Washington as resolutely indifferent to their needs and problems, a tendency which political loyalties do not now conceal. It is a tension no one needs. The New Federalism, there is little doubt, is an unduly transparent device for shifting public costs away from the personal and corporate income tax bases of the federal government with the particular incidence on the affluent to the more regressive sales and property tax bases of states and localities.

Mr. Stockman, with admirable candor, said last year that the concept of supply-side economics and its associated rhetoric were also a cover for the reduction of income taxes, the perceptible gain again being in the upper brackets. That conservatives should seek a reduction in the upper-income-tax brackets is not remarkable; not less than liberals, conservatives have their constituency. What is not forgivable is that conservatives should disguise their purposes behind supply-side rhetoric or that of a New Federalism. Plain speech is proper to people of all political faiths.

Conservatives especially should not accept the deficit in its prospective magnitude. There is room for ideological difference on how public services should be financed. There is no room for difference on the question of whether or not they should be financed. Deficits on the scale now projected effectively remove all freedom of economic action and commit the government to a monetary policy that we have already learned -- as the British have learned -- is painfully repressive and potentially disastrous.

Chairman **Domenici**. Dr. **Greenspan**.

STATEMENT OF ALAN GREENSPAN, PRESIDENT, TOWNSEND-GREENSPAN & CO., INC.

SHORT-TERM BUSINESS OUTLOOK

Dr. **Greenspan**. Thank you very much, Mr. Chairman.

I would like to first discuss the short-term business outlook since actions being taken by this committee likely to be very significantly impacted by the trend of the economy over the next several months. Retail activity seemed to be mixed in February, but sales of durables other than motor vehicles were weak. However, given the rise in car sales, it was feared that the rapid decline in consumer spending from August through December has been checked. Industrial production for the first 3 weeks of February also showed fairly small change from January after, as you know, a very significant decline in the previous months. Motor vehicles and parts were up to the equivalent of about three-tenths of a point on the total index relative to January.

Steel, petroleum refining, utilities and mining were all off a shade, and although data are not available for heavy capital equipment producers, their production probably was also somewhat lower. However, while capital goods stretch-outs and delays are widespread, there are few instances of major project cancellations. This should help to hold up capital goods production. Defense production is apparently speeding up following the release of significant budget funds. Output of defense equipment was increasing very slowly in late 1981 but there is evidence of some acceleration currently.

Overall, inventory liquidation seems to be continuing—despite the fact that inventory levels are low—but unfilled orders, especially of materials, are continuing to decline, indicating that new orders are running under shipments and, of course, significantly below consumption. The first signs of the recovery should be reflected in new orders as they first close the gap with shipments and then rise to the consumption level or above. This is the typical behavior during an inventory correction and usually occurs somewhat before the turn in the economy. However, there is very little in the way of strength evident in materials orders. Steel orders, in particular, remain very poor. Other metals and materials orders are mixed to poor and scrap prices have continued to slide in February. This also suggests a weak order situation.

A second early indicator of an upturn in the economy is a rise in the number of workers being rehired relative to those being laid off. There is no evidence yet of this occurring. Because of the distortions created by February holidays, it will be early March before any clear signal would be apparent in these data.

Thus, while the evidence suggests the rate of decline is slowing and, in fact, we may have hit bottom, indications of an upturn are scant at best.

ECONOMIC OUTLOOK MORE FAVORABLE WITH PRESIDENT'S PROGRAM

If the Congress were to pass the President's budget and tax recommendations in total, the economic outlook would be far more favorable than appears at this time. To be sure, there are, as in all budgets, some optimistic assumptions unrelated to Congressional actions.

I am sure that with the weakening of crude oil prices worldwide, the administration is reaching a bit in the level of oil and gas leasing revenues shown for fiscal 1983 and beyond. They are also probably a bit optimistic in their cost estimates of agricultural support programs and in some of their so-called revenue enlargements from management initiatives. Hence, the President's recommendations, if implemented, will probably create a somewhat higher deficit than was reported in his budget message. Nonetheless, it would fall far short of the current fears of the financial community and surely far short of the deficit levels that are already discounted in long-term interest rates.

In any event, if actual receipts and outlays for fiscal 1983 through fiscal 1987 even roughly approximate those which are now projected in the President's budget, interest rates would fall substantially over the next several years, capital investment would be higher and recoveries in housing and, therefore, in autos and related materials businesses would be reasonably assured.

The President's budget, in my judgment, is a sensible set of recommendations that takes into consideration, and balances, the needs of national security and the economy.

That is not to say that it is the President's program or no other. There are inevitable value judgments applied to the construction of any Federal budget. Reasonable people can differ on priorities, as well as degrees of risks to the economy and to national defense. But every variation from the President's program, lessening the budget deficit for example, creates problems for some other segment of our structure of goals and priorities. The choices are, as usual, between bad alternatives and worse.

REDUCE GROWTH RATE IN DEFENSE OUTLAYS

However, since I believe there is a bias toward deficits built into our fiscal process, we have to shoot for a much lower Federal budget deficit in the outyears than we think can reasonably be absorbed by the economy. As a consequence, I would be willing to risk, and it is indeed a risk, slimming down the rate of growth in defense outlays.

It is extraordinarily difficult to know what is the right balance to insure our national security. We have to forecast not only the actions of our potential adversaries but the effectiveness of their weaponry and ours under conditions not experienced previously. We are also required to evaluate potential dangers which, if we are wrong in our judgments and responses, risk the continuation of our civilization.

There is almost no way to know the optimum strategic and tactical balance except to assume that the more resources we commit, other things being equal, the lower the military risk to this country. Nonetheless, the degree of security that this Nation has and its ability to maintain a viable defense establishment presupposes, as it has in past generations, a viable economy. There is clearly a tradeoff, especially in today's environment between the Federal deficits, inflation, and economic viability on the one hand, and the degree of military spending on the other. In real terms, we have escalated the level, for example, of fiscal 1985 projected outlays during the past year to significantly more than was allocated in the Carter budget for that year. I have no idea how much can or should be cut from the defense budget. I am not privy to the latest security evaluation which one must surely be conversant with before making such judgments. I do, however, hope that it would be possible, without significantly increasing strategic risks, to lower the rate of growth in defense outlays. A restoration of the 7-percent real annual rate of growth recommended in President Reagan's defense budget last year would leave outlays, for example, for fiscal 1985 more that $20 billion less than currently projected. I do not imagine such a retrenchment would be easy to implement. One addresses specific programs and, needless to say, when we get involved in program-by-program, line-by-line budget analysis, what may appear at this stage to be in the Congress a large consensus for paring President Reagan's defense budget is surely going to be tested when individual programmatic changes are subject to deliberation.

CORPORATE TAX STRUCTURE

There has been considerable discussion related to the repeal of the so-called Safe Harbor Leasing provisions of the 1981 Tax Act. That is certainly a notion superior to a minimum tax on corporations as a means to offset some of the negative effects of the leasing provisions. But there is something more profoundly wrong with our corporate tax structure.

When the investment tax credit was originally proposed in the early 1960's, it was understood that corporations without tax liability could not benefit from this provision unless there was a refundable investment tax credit which, in effect, would convert the investment tax credit to a subsidy for equipment investment. Inflation accelerated and it became fairly evident that depreciation charges based on original cost were failing to recognize rapidly accelerating replacement costs of equipment. This led to major changes in depreciation practice embodied in the Economic Recovery Act of 1981. This, in turn, created an extraordinarily large number of corporations who were unable to use part or all of the tax benefits created in last year's act. This in turn led, not unexpectedly, to the new leasing provisions which enabled the sale of tax benefits by those who could not use them. But that, in turn, created the odd corporation with seeming significant profits, mainly from abroad, who were able to sell not fully usable domestic tax credits. The "scandal" led to the administration's recommendation of a minimum corporate tax to offset the effects of the leasing provision. What next tax initiative can we expect to offset the negative effects of the minimum tax?

It is perhaps time for us to reconsider this gerry-built corporate tax structure and possibly simplify the system by converting most of the nonrate corporate tax benefits into rate reductions. It should not be too difficult to convert all of the capital investment-inducing benefits into a substantial cut in the corporate rate. The net effect of such a change, I suspect, could be a major improvement in the decisionmaking process of corporate America. Corporate managers would be less involved in trying to maximize the use of tax benefits and could focus on profitability. It is quite posisible that we can bring the corporate tax rate down more than 10 points and still actually increase corporate revenues available to narrow the deficit. This would eliminate much of the pressure for mergers and acquisitions to obtain tax credits for the leasing provision. This would significantly reduce the negative impact of inflation on depreciation charges which the accelerated depreciation code of last year was addressed to correct. The lower the corporate rate, the less the negative impact on aftertax earnings of inflation distorted depreciation charges. It would increase the incentives for general efficiency and productivity improvement since more pretax profit will flow to aftertax earnings. It would eliminate the emerging bias between corporations in heavily capital intensive industries and those in the more R. & D. intellectual labor intensive operations.

Many of the problems that we ascribe to inflation's impact on the corporate rate are clearly reduced by merely cutting the rate itself. Hopefully, we may eventually eliminate the corporate tax completely as a questionable device for raising revenues for our budgetary process.

INDIVIDUAL INCOME TAX CHANGES

I would not recommend, however, any alteration of the individual income tax changes embodied in the 1981 Revenue Act. They were addressed originally to offset the effects of inflation on individuals, taxes, what we have now dubbed "bracket creep." Without the tax cuts scheduled to go in place this year and next followed by indexing, the real tax burden of individuals, on average, would have risen. Tax receipts as a percent of adjusted gross incomes, would have risen by approximately 1 percent per year over the next 5 years. The new legislation effectively prevents that from happening. If we rescind or delay part of the scheduled tax cuts, we will, in effect, be acquiescing in increasing tax burdens on individuals. It strikes me that having solved one of the major problems confronting this country in last year's legislation, it probably would be wise to chalk up the victory and go on to the next problem.

In summary, therefore, let me say that of all the various alternatives that I have seen, with respect to the budget process for the forthcoming year, I believe the President has struck on the least worse solution to a very difficult set of problems. I suspect that as the Congress deliberates further this year, it will confront the same sort of seemingly impossible choices that the President has had to confront. The worst alternative at this stage is to do nothing, that is, to allow expenditures to move on their current services path generating a budget deficit substantially in excess of $140 billion for fiscal 1983, with larger numbers in the outyears. Next worst, is allowing the individual income tax cuts currently scheduled to be delayed or canceled.

Thank you.

Chairman **Domenici**. Thank you very much.

Dr. **Eckstein**.

STATEMENT OF OTTO ECKSTEIN, CHAIRMAN, DATA RESOURCES, INC., AND PAUL M. WARBURG PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

Dr. **Eckstein**. Mr. Chairman, members of the committee, first I would like to congratulate the committee for the prompt response shown by the chairman and the senior Democratic member in proposing alternatives to the budget advanced by the administration. I think this committee reached its final finest hours in recent weeks, and I hope you will continue your efforts to rescue this budget.

Over the past 4 years, I have testified before various Congressional committees that the Federal Government must come to grips with its budget. But even in my wildest imagination I could not foresee a budget as extreme as the one before us. Who could have thought that a President would propose a 17 percent a year increase in military spending for 4 years while simultaneously obtaining the largest tax cuts in American history? Have we learned nothing at all from the economic policy mistakes of the Vietnam War? The President's budget strategy rests on spending cuts and supply-side miracles, but with social security ruled off limits to the cuts, the rest of the civilian budget is forced into a totally unrealistic posture both in political and economic terms. The ratio of nonmilitary, non-social security, non-interest spending to GNP, under the President's proposals, would be rolled back not to the levels of 1970, but to the levels of 1940.

Many people are hoping that the Congress will straighten out the budget and put it on a more realistic path toward balance. I expect that the Congress will improve the budget somewhat, but it cannot solve the problem without Presidential cooperation. It will be extremely difficult for the Congress to pass major revenue-raising measures over Presidential opposition and subject itself to the political risk of being criticized as "tax raisers." The budget outlook is, indeed, grim, unless the President shares in the leadership required to achieve more sensible results.

ECONOMIC OUTLOOK

Before turning to the budget, let me quickly sketch the economic outlook. Table 1 in my prepared statement,[1] compares the DRI forecast with the budget assumptions. The differences are not large, though the DRI projections are somewhat more cautious. We look for real growth of 3.9 percent in the 2 years succeeding the mid-1982 tax cuts, the administration projects 5.1 percent. Our inflation figure for the next 2 years averages 6.9 percent for the GNP deflator, the administration projects an improvement to 5.5 percent. Our estimate for the Treasury bill rate for the year 1983 is 12 percent, the Government assumes 10.5 percent.

The logic of the forecast is simple enough. The inventory correction runs its course by spring and consumer spending is then aided by the $40 billion injection of purchasing power from the 10 percent tax cut and the escalation of social security benefits. Interest rates will rise by the end of this year because of deficits and recovery running up against the monetary targets, but we assume that the Federal Reserve will interpret monetarism in a somewhat eclectic fashion, looking at various aggregates and not attempting to fine tune the money growth path beyond what is in fact feasible. As a result, interest rate volatility should diminish from what it has been for the last 2 years, permitting the next credit cycle to be less damaging than the cycles of 1980 and 1981. Recovery is able to proceed, led by consumers and housing, with business fixed investment coming along a little later. The recovery will be abnormal because real interest rates will be kept high by crowding out created by the Federal budget and past rate volatility.

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[1] See p. 223.

The inflation improvement is particularly dramatic at this time, because of cyclical forces, relief from OPEC, and declines of interest rates. For example, the January Consumer Price Index, which rose only by 0.3 percent, showed a reduction in home purchase prices, financing, taxes and insurance of 0.3 percent, a component which accounts for almost one-quarter of the index. A 1.7 percent drop in gasoline prices also was an important contributor to the good results. Food prices actually rose a full percentage point in January.

Once the recovery gains momentum, the inflation outlook will not remain quite so favorable. Industrial prices will be boosted by the defense boom, by the restoration of more normal profit margins, by some increases of energy prices, and by a weakening of the dollar. The moderation in wages is coming more gradually, but with major collective bargains held down by industry distress, the improvement is likely to persist. Whereas compensation was rising at 10 percent just a few months ago, it appears headed for the 7- to 8-percent range for the next several years. With a more moderate trend in capital costs and a better unit labor cost trend in prospect, a core inflation rate in the 6 to 7 percent range, is a major accomplishment. Let me spend a few moments on the budget and the items which are not likely to materialize.

REALISTIC VIEW OF REAGAN BUDGET

The President's budget projects a deficit of $98.6 billion for 1982 and small declines thereafter. But this budget must be considered unrealistic. See table 2 in my prepared statement.[1] It includes tax increases which have failed of passage in previous Congresses and which are not being pushed aggressively by the administration. It also includes a set of outlay reductions which are not likely to materialize. The differences in economic assumptions also cause some small increases in the deficits, but this is not the major source of variation. While the DRI real growth forecast is lower and interest rate projections higher, we project somewhat more inflation which produces a lot of extra revenue. Let me give you a few examples which are not likely to materialize. The budget assumes a near doubling of the profitability of the insurers of bank and savings and loan deposits from $1.8 billion to $2.5 billion. Given the bad results of the savings and loans and the in mergers and the subsidies which they are permitted by contract to provide, the deficits will be large and, indeed, are a part of this major problem.

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[1] See p. 226.

Senator BOSCHWITZ. Where are you reading from?

Dr. ECKSTEIN. No, this is not in my testimony. These are things that I dug out of the budget which any reasonable reader would find.

The veterans hospitals are scheduled to increase in cost by 4 percent per year, even though the number 65 years of age is exploding, because it has been long enough for the World War II veterans to reach that age.

Of course, you are all familiar with the more obvious cases, the oil and land leases, which are supposed to bring in $18 million. There is some political question whether the Farmers Home Administration is going to be ground from $11 billion in 1982 to virtually nothing in 1984. So the budget is unrealistic and even the most basic corrections bring you to a deficit estimate for this budget of $130 billion without changing anything of substance, just correcting it.

DEFICIT ESTIMATES UNCERTAIN

We should also emphasize, however, that the uncertainty surrounding the estimates of the budget deficit is very large. DRI analyzes this kind of uncertainty with a stochastic analysis. We run 100 simulations of our model, using random error terms based on the historical errors of each equation, and allowing for serial correlation and error correlation across equations. Exogenous variables, including the budget and monetary policy, are also treated stochastically, using historical variation from trend as the estimate for future variance. The results of this exercise are shown in chart 2 of my prepared statement.[1] It can be seen that the range of outcomes stretches from a deficit of $84 billion to a deficit of $174 billion, with a probability of 0.90 that it will fall between $97 billion and $170 billion, and a probability of 0.50 that it will fall between $118 billion and $149 billion. The source of this uncertainty lies mainly in the economy, and not based much on the budget. This goes with different kinds of economies then, including some with higher growth and less inflation and some with lower growth and more inflation.

What is to be done? What are some of the possibilities? I really have not had an opportunity to analyze in detail either the Domenici or the Hollings proposals. But here is just a plausible, rather simple set of suggestions on how it might be improved, which is summarized in table 3 of my prepared statement,[2] and the focus is on both revenues and expenditures, including the scaling back of some of the proposed cuts which are unlikely anyway.

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[1] See p. 227.

[2] See p. 228.

ALTERNATIVES FOR A SOUNDER BUDGET

Now, let me focus on the three principal areas in which you have to focus if you want to fix this budget.

First, the administration budget contains increases in defense spending which are so enormous that they probably could not be accomplished even if attempted, and which surely could not be executed without enormous waste and inefficiency. While the total defense budget rises from $160 billion to $292 billion between 1981 and 1985, an increase of 83 percent, the procurement portion rises an incredible 151 percent, from $35 billion to $88 billion. Outlays for operation and maintenance and military personnel actually rise rather moderately, apparently continuing the pattern of previous administrations in which there is a fascination with exotic and overdesigned hardware and inadequate support for training and operations. Congress can easily find large savings in the procurement budget.

Social security, including medicare, represents about half of all civilian expenditures. To achieve the total cuts proposed by the President, some changes in the social security program would have to be made. The most obvious change would be to temporarily reduce the degree of indexing, if only to compensate for the overindexing of the last few years.

Congress could also enact more fundamental changes such as a reversal of the downtrend in the retirement age. The minimum benefit provision is also an appropriate item for reform, since a significant portion of it is paid to people who worked in the United States for only a relatively short period before returning to their native country and to "double dipping" retired public employees. But it would be hard to justify a social security reform which only affects the lowest income stratum.

To make a major impact on the budget, however, a broad personal tax increase is a necessity. Postponing the final step of the personal income tax reduction program until we can afford it would save at least $33 billion for fiscal 1984 and is the obvious thing to do—to correct last year's mistake. But if ideology or false pride makes it impossible for the administration to accept this change, a national security surcharge could accomplish the same goal. It would also be quite appropriate because, in truth, the budget problem is created by the enormity of the defense buildup and the unwillingness to pay for it. When the defense budget has passed through its rapid expansion phase, the national security surcharge could perhaps be removed. In the meantime, it will remind the public what the taxes are buying.

BENEFITS OF A SOUNDER BUDGET

What would be the benefit of the kind of program sketched in table 4 of my prepared statement? [1] A DRI model solution gives some of the basic dimensions. The model includes an elaborate representation of the financial system, and so the impact of the deficits on funds flows and interest rates are calculated. The extent of crowding out of private capital formation depends upon the economic conditions. Thus, in 1982, the deficit is not all that damaging because the recession is holding down private credit demands. But during the recovery, the crowding out becomes more substantial though it does not come close to the dollar-for-dollar figures that seems to underlie the more extreme viewpoints in the financial community. Even with the large deficits, the economy staggers through a recovery with a 4-percent growth trend, the weakest recovery of any postwar recovery except the aborted 1980 episode, but recovery nonetheless.

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[1] See p. 230.

You can see in table 4 what those reductions are. The Treasury bill rate would be lowered substantially. On the supply side, it would mean that the Reagan tax program is benefits would occur at least to a limited extent. The net effect is to hurt on the supply side. Inflation would be a bit better, about three-fourths of a percentage point. Housing would be much better, about 160,000 housing units. Initially, activity would be little, but the improvements of financial situations would raise real activity.

COUNTRY FACING LARGEST DEFICITS IN RELATION TO GNP

Let me just summarize very briefly.

A realistic assessment of the Reagan budget leads to the inescapable conclusion that the country is facing the largest deficits in relation to GNP in postwar history. Individual years may have shown larger deficits, but no 4-year Presidential interval approaches the levels now in prospect. The Reagan deficits, in relation to GNP, will be greater than those of Presidents Carter, Ford, Nixon, Johnson, Kennedy, Eisenhower, or Truman. These deficits occur in a time when the financial system has been weakened by decades of worsening business balance sheets and excessive public borrowing. The risks of aborting the recovery are heightened and the supply-side benefits of the Reagan tax programs are nullified by the boosts in capital costs created by crowding out.

The case for improving the proposed budget is overwhelming. I urge the Congress to cut back some of the extraordinary increases in defense spending, to slow down the reduction of personal income taxes to a more realistic pace, and to face up to the challenge of social security reform.

I recognize the difficulty of having the Congress rescue the budget. If the President is not a party to the effort, by coming up with new proposals or accepting congressional ideas, the prospect for the rescue is quite remote. Congress has never engaged in a major tax increase over Presidential opposition, and it is unreasonable to expect them to do so now. My plea, this year, is therefore particularly addressed to the President, to exercise the pragmatic leadership which will be needed to avert a series of budget disasters.

Thank you.

Chairman DOMENICI. Thank you very much.

PREPARED STATEMENT OF OTTO ECKSTEIN, CHAIRMAN, DATA RESOURCES, INC., AND PAUL M. WARBURG PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

CAN THIS BUDGET BE RESCUED?

Over the past four years, I have testified before various Congressional committees that the Federal government must come to grips with its budget. But even in my wildest imagination I could not foresee a budget as extreme as the one before us. Who could have thought that a President would propose a 17% a year increase in military spending for four years while simultaneously obtaining the largest tax cuts in American history? Have we learned nothing at all from the economic policy mistakes of the Vietnam War? The President's budget strategy rests on spending cuts and supply-side miracles, but with Social Security ruled off limits to the cuts, the rest of the civilian budget is forced into a totally unrealistic posture both in political and economic terms. The ratio of non-military, non-Social Security, non-interest spending to GNP, under the President's proposals, would be rolled back not to the levels of 1970, but to the levels of 1940.

Many people are hoping that the Congress will straighten out the budget and put it on a more realistic path toward balance. I expect that the Congress will improve the budget somewhat, but it cannot solve the problem without Presidential cooperation. It will be extremely difficult for the Congress to pass major revenue-raising measures over Presidential opposition and subject itself to the political risk of being criticized as "tax raisers". The budget outlook is, indeed, grim, unless the President shares in the leadership required to achieve more sensible results.

THE ECONOMIC OUTLOOK

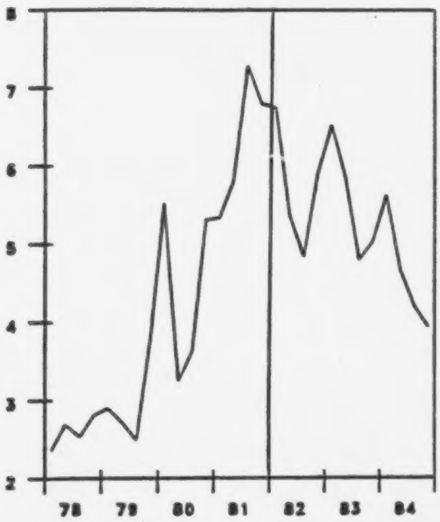
Before turning to the budget, let me quickly sketch the economic outlook. Table I compares the DRI forecast with the budget assumptions. The differences are not large, though the DRI projections are somewhat more cautious. We look for real growth of 3.9% in the two years succeeding the mid-1982 tax cuts, the Administration projects 5.1%. Our inflation figure for the next two years averages 6.9% for the GNP deflator, the Administration projects an improvement to 5.5%. Our estimate for the Treasury Bill rate for the year 1983 is 12.0%, the government assumes 10.5%.

Table I
Economic Forecasts, 1982-1984
(Calendar Years)

	1982		1983		1984	
	Reagan Budget	DRI*	Reagan Budget	DRI*	Reagan Budget	DRI*
	(Percent Change, 4th Quarter Over 4th Quarter)					
GNP						
Current Dollars	10.4	8.0	11.0	11.8	10.0	10.0
Constant (1972) Dollars	3.0	1.2	5.2	4.3	4.9	3.5
GNP Deflator	7.2	6.7	5.5	7.2	4.9	6.3
GNP						
Current Dollars	3160	3109	3524	3478	3883	3834
% Change, Year-Over-Year	8.1	6.3	11.5	11.9	10.2	10.2
Constant (1972) Dollars	1513	1495	1591	1559	1670	1613
% Change, Year-Over-Year	0.2	-1.0	5.2	4.3	5.0	3.5
GNP Deflator (1972=1)	2.089	2.080	2.215	2.231	2.325	2.376
% Change, Year-Over-Year	7.9	7.4	6.0	7.3	5.0	6.5
Unemployment Rate (%)	8.9	9.1	7.9	8.5	7.1	7.8
Interest Rate, 3-Month Treasury Bill (%)	11.7	11.4	10.5	12.0	9.5	11.1

The logic of the forecast is simple enough: the inventory correction runs its course by spring and consumer spending is then aided by the $40 billion injection of purchasing power from the 10% tax cut and the escalation of Social Security benefits. Interest rates will rise by the end of this year because of deficits and recovery running up against the monetary targets, but we assume that the Federal Reserve will interpret monetarism in a somewhat eclectic fashion, looking at various aggregates and not attempting to fine-tune the money growth path beyond what is in fact feasible. As a result, interest rate volatility should diminish from what it has been for the last two years, permitting the next credit cycle to be less damaging than the cycles of 1980 and 1981. Recovery is able to proceed, led by consumers and housing, with business fixed investment coming along a little later. The recovery will be subnormal because real interest rates will be kept high by crowding out created by the federal budget and past rate volatility.

Chart I
Real Bond Interest Rate
(Percent)



The inflation improvement is particularly dramatic at this time, because of cyclical forces, relief from OPEC and declines of interest rates. For example, the January Consumer Price Index, which rose by only 0.3%, showed a reduction in home purchase prices, financing, taxes and insurance of 0.3%, a component which accounts for almost one-quarter of the index. A 1.7% drop in gasoline prices also was an important contributor to the good results. Food prices actually rose a full percentage point in January.

Once the recovery gains momentum, the inflation outlook will not remain quite so favorable. Industrial prices will be boosted, by the defense boom, by the restoration of more normal profit margins, by some increases of energy prices and by a weakening of the dollar. The moderation in wages is coming more gradually, but with major collective bargains held down by industry distress, the improvement is likely to persist. Whereas compensation was rising at 10% just a few months ago, it appears headed for the 7-8% range for the next several years. With a more moderate trend in capital costs and a better unit labor cost trend in prospect, a core inflation rate in the 6½-7% range is emerging.

A REALISTIC VIEW OF THE REAGAN BUDGET: $130 BILLION DEFICITS IN 1983 AND 1984

The President's budget projects a deficit of $98.6 billion for 1982 and small declines thereafter. But this budget must be considered unrealistic (see Table 2). It includes tax increases which have failed of passage in previous Congresses and which are not being pushed aggressively by the Administration. It also includes a set of outlay reductions which are not likely to materialize. The differences in economic assumptions also cause some small increases in the deficits, but this is not the major source of variation. While the DRI real growth forecast is lower and interest rate projections higher, we project somewhat more inflation which produces a lot of extra revenue.

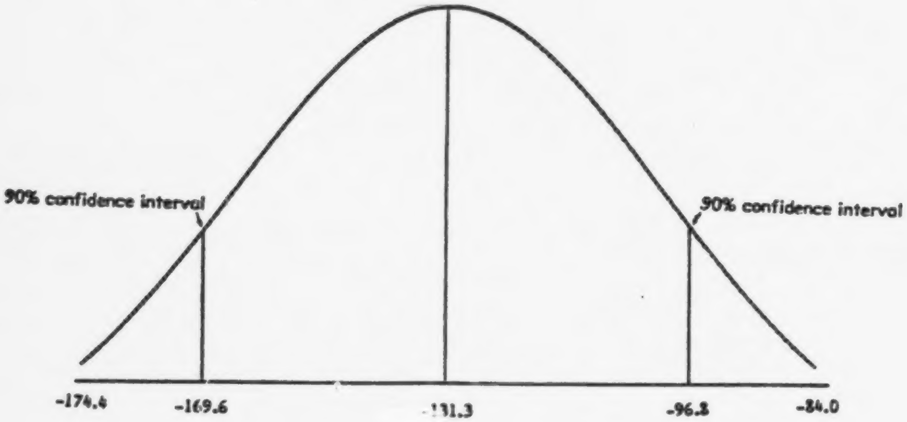
It should also be emphasized that the uncertainty surrounding the estimates of the budget deficit is very large. DRI analyzes this kind of uncertainty with a stochastic analysis. We run 100 simulations of our model, using random error terms based on the historical errors of each equation, and allowing for serial correlation and error correlation across equations. Exogenous variables, including the budget and monetary policy, are also treated stochastically, using historical variation from trend as the estimate for future variance. The results of this exercise are shown in Chart 2. It can be seen that the range of outcomes stretches from a deficit of $84 billion to a deficit of $174 billion, with a probability of .90 that it will fall between $97 billion and $170 billion, and a probability of .50 that it will fall between $118 billion and $149 billion. The source of this uncertainty lies mainly in the economy. The enormous deficits at the pessimistic end of the distribution are created by an economy in which there is no improvement in the instability of the financial system, inflation improves less, and the confidence of consumers and business is set back further by poor economic performance. At the optimistic end of the probability distribution, inflation is better, interest rates are lower and real growth is higher. However, none of the solutions are quite up to the Administration forecast.

Table 2
Realistic Budget Before New Actions
(Billions, Unified Budget, Fiscal Years)

	1982	1983	1984
Reagan Deficit	-98.6	-91.5	-82.9
Improbable Tax Increases:	(-0.3)	(-13.9)	(-20.3)
Completed Contract Accounting		-3.3	-5.0
Withholding on Interest and Dividend Income		-2.0	-1.3
Improved Collection and Enforcement	-0.2	-3.5	-4.1
Airport and Airway Trust Fund	-0.1	-1.2	-1.4
Other		-3.9	-8.5
Improbable Outlay Reductions:	(-1.0)	(-18.8)	(-23.8)
Entitlements:			
Medicare Cuts	-0.1	-0.7	-2.9
AFDC Cuts	-0.2	-1.2	-1.1
Food Stamp Cuts	-0.3	-2.4	-2.8
Guaranteed Student Loan Cutbacks	-0.2	-0.8	-1.1
One-Half of Medicaid Savings	-0.1	-1.0	-1.1
Management Initiatives			
Property Disposal		-1.0	-4.0
Offshore Leasing		-8.4	-7.8
Asset Sales	-0.1	-1.3	-1.0
FHA Mortgage Insurance		-0.7	-0.7
Other (Interest Savings)		-1.3	-1.3
More Realistic Economic Assumptions:	(-8.2)	(-7.8)	(-4.0)
Real GNP Growth	-6.6	-17.1	-36.3
Inflation	-1.6	12.1	38.1
Interest Rates	0.0	-2.8	-5.8
Adjusted Deficit	-108.1	-132.0	-131.0

Source of Underlying Data: Office of Management and Budget, February 1982, and DRI Estimates.

Chart 2
Probability Distribution of the Federal Deficit
(Billions of Dollars, Average Fiscal 1982-1984)



TOWARD A SOUNDER BUDGET: A NATIONAL SECURITY SURCHARGE AND OTHER PROPOSALS

Various proposals are being developed in the Congress to try to improve the fiscal 1983 budget. Table 3 contains one set of proposals, focusing both on new tax revenues and expenditure reductions, but partially offsetting these measures with a scaling back of the proposed Reagan cuts. Without discussing each item in detail, let me focus on the three principal (and unavoidable) areas in which the budget improvement must be sought.

Table 3
A Proposed Alternative Budget Program
(Billions, Unified Budget, Fiscal Years)

	1983	1984
Adjusted Administration Budget	-132.0	-131.0
Taxes:	24.6	55.8
Eliminating or Postponing July 1, 1983 Personal Tax Cut	7.7	32.6
Eliminating Leasing Provisions	3.5	6.1
$5000 Ceiling on Mortgage Interest Deductions	3.0	5.4
Income on Discs	1.7	1.8
Interest on State and Local Industrial Revenue Bonds	1.6	1.9
Interest on Consumer Credit	7.1	8.0
Outlays:	14.6	28.8
Defense:	10.1	19.8
"Big Ticket" Items (MX Missile, B1 Bomber, F-18 Fighter, Two Nuclear Carriers)	5.8	10.0
Across the Board 2% Cut in 1983 and 4% in 1984	4.3	9.8
Nondefense:		
Indexing Social Security to 3 Percentage Points Less Than the CPI	4.5	9.0
Tough Budget Including Reagan Cuts	-92.8	-46.4
Acceptance of Reagan Nondefense Reductions		
Limit Entitlement Reductions to One-half	-3.4	-4.6
Limit Discretionary Programs Reductions to One-half	-6.5	-12.4
Reduced Deficit Under This Program	-102.7	-63.4

Source of Underlying Data: Office of Management and Budget, Congressional Budget Office, and DRI Estimates.

First, the Administration budget contains increases in defense spending which are so enormous that they probably could not be accomplished even if attempted, and which surely could not be executed without enormous waste and inefficiency. While the total defense budget rises from $160 billion to $292 billion between 1981 and 1985, an increase of 83%, the procurement portion rises an incredible 151%, from $35 billion to $88 billion. Outlays for operation and maintenance and military personnel actually rise rather moderately, apparently continuing the pattern of previous administrations in which there is a fascination with exotic and over-designed hardware and inadequate support for training and operations. Congress can easily find large savings in the procurement budget.

Social Security including Medicare represents about half of all civilian expenditures. To achieve the total cuts proposed by the President, some changes in the Social Security program would have to be made. The most obvious change would be to temporarily reduce the degree of indexing, if only to compensate for the overindexing of the last few years. Congress could also enact more fundamental changes such as a reversal of the downtrend in the retirement age. The minimum benefit provision is also an appropriate item for reform, since a significant portion of it is paid to people who worked in the United States for only a relatively short period before returning to their native country and to "double dipping" retired public employees. But it would be hard to justify a Social Security reform which only affects the lowest income stratum.

To make a major impact on the budget, however, a broad personal tax increase is a necessity. Postponing the final step of the personal income tax reduction program until we can afford it would save at least $33 billion for fiscal 1984 and is the obvious thing to do--to correct last year's mistake. But if ideology or false pride makes it impossible for the Administration to accept this change, a National Security Surcharge could accomplish the same goal. It would also be quite appropriate because, in truth, the budget problem is created by the enormity of the defense buildup and the unwillingness to pay for it. When the defense budget has passed through its rapid expansion phase, the National Security Surcharge could perhaps be removed. In the meantime, it will remind the public what the taxes are buying.

BENEFITS OF A SOUNDER BUDGET

What would be the benefit of the kind of program sketched in Table 4? A DRI model solution gives some of the basic dimensions. The model includes an elaborate representation of the financial system, and so the impact of the deficits on funds flows and interest rates are calculated. The extent of crowding out of private capital formation depends upon the economic conditions. Thus, in 1982 the deficit is not all that damaging because the recession is holding down private credit demands. But during the recovery the crowding out becomes more substantial though it does not come close to the dollar-for-dollar figures that seems to underlie the more extreme viewpoints in the financial community. Even with the large deficits, the economy staggers through a recovery with a 4% growth trend, the weakest recovery of any post-war recovery except the aborted 1980 episode, but recovery nonetheless.

Table 4
Economic Benefits of Reducing Budget Deficits
(Difference From Baseline)

	1983	1984
Real GNP Growth Rate (%)	0.1	0.3
Car Sales (Million Units)	0.1	0.1
Housing Starts (Million Units)	0.098	0.263
Unemployment Rate (%)	0.0	-0.1
Inflation Rate (%)	-0.5	-0.7
91 Day T. Bill Rate (%)	-0.94	-1.65
Deficit Reduction (Billions)	44.0	76.8

An improvement of the budget would have sizable benefits to the economy. The Treasury Bill rate would be 165 basis points lower. The level of business fixed investment would be 1.4% higher in 1984, promoting capital formation and the recovery of the productivity trend; the improvement to the supply side of the economy meant to be created by the Reagan tax program would occur at least to a limited extent. Inflation would improve by 0.7 percentage points in 1984, and the level of housing activity would be boosted by a large 263,000 units. Total real activity would be somewhat lower initially, of course, because a part of the fiscal stimulus emanating from the budget would be removed. But the healthier evolution of the financial system would have additional investment benefits in later years.

CONCLUSIONS

A realistic assessment of the Reagan budget leads to the inescapable conclusion that the country is facing the largest deficits in relation to GNP in post-war history. Individual years may have shown larger deficits, but no four-year Presidential interval approaches the levels now in prospect. The Reagan deficits, in relation to GNP, will be greater than those of Presidents Carter, Ford, Nixon, Johnson, Kennedy, Eisenhower or Truman. These deficits occur in a time when the financial system has been weakened by decades of worsening business balance sheets and excessive public borrowing. The risks of aborting the recovery are heightened and the supply-side benefits of the Reagan tax programs are nullified by the boosts in capital costs created by crowding out.

The case for improving the proposed budget is overwhelming. I urge the Congress to cut back some of the extraordinary increases in defense spending, to slow down the reduction of personal income taxes to a more realistic pace, and to face up to the challenge of Social Security reform.

I recognize the difficulty of having the Congress rescue the budget. If the President is not a party to the effort, by coming up with new proposals or accepting Congressional ideas, the prospect for the rescue is quite remote. Congress has never engaged in a major tax increase over Presidential opposition and it is unreasonable to expect them to do so now. My plea, this year, is therefore particularly addressed to the President, to exercise the pragmatic leadership which will be needed to avert a series of budget disasters.

REDUCE PROJECTED OUTLAY GROWTH

Chairman **Domenici**. I just have a couple of questions and then I will yield in this order: Hollings, Gorton, Moynihan, Boschwitz, Kasten, and Exon.

It appears to me that all three of you are suggesting that we ought to reduce the deficits.

Dr. Galbraith, I did not give you a chance to go into your notions on military curtailment in terms of the increased growth, and I do not know that I will, but I would like to focus on a statement you made about entitlements. I am not sure that your definition of entitlements is the same as mine. You, however, start with the premise. that we must first reduce the growth of the Federal budget before we look at the tax side.

I would first ask each of you, without details on how, to discuss military reductions.

Would you agree with the premise that between 1982, 1983, 1984, and 1985 that we have to reduce the projected growth on the outlay side of this budget significantly? Would you agree that we must do that or not?

Dr. **Galbraith**. Well, taking military and civilian expenditures together, I think I would.

I am very uneasy, Senator, about any substantial further cuts on the civilian side of the budget apart from some possibilities which are politically so well wired—water projects, agricultural subsidies—that we can leave them aside.

Going back to my testimony, we should not forget that one of the things that has made our capitalist system acceptable, one of the things that has helped in its survival, is that it no longer seems as impersonal and cruel as it did 50 or 100 years ago.

Chairman **Domenici**. I understand that but I am not sure that——

Dr. **Galbraith**. So I would be very reluctant to endorse in any way the cuts in civilian expenditures that are contemplated in the budget for this coming year.

Chairman **Domenici**. I will go into some details with you in entitlements in a moment, because I am not sure that you have the same figures that we have. Dr. Greenspan, do you agree, before you looked at any significant tax increases, that we must further reduce the growth of the Federal budget in the next 3 to 5 years?

Dr. **Greenspan**. Yes; Mr. Chairman, I do. I think it is imperative that they work——

Chairman **Domenici**. Dr. Eckstein.

Dr. **Eckstein**. There are lots of items that should be cut even in the civilian side.

ENTITLEMENTS

Chairman **Domenici**. Let me share with you the entitlements for just a moment because I remember you saying that we should not cut them further.

If you go to last year's final product, which was reconciliation ordering reductions plus the omnibus appropriation bill, the continuing resolution, you have the following facts: Entitlements were reduced in growth by 2.8 percent, 2.8 percent, 3 percent for the years 1982, 1983, and 1984.

Nonentitlements were cut, in round numbers, 12 percent 1982; 15 percent for 1983; 17 percent for 1984. If you look at the President's new budget, you have the following: Entitlements will grow at a nominal growth of 11.2 percent during that time frame. Defense will grow nominal growth of 13.7 percent. Nondefense, nonentitlements will grow in real teams a negative 3.6 percent.

PENSIONS

Now, just taking a large entitlement program called pensions, social security, Federal retirements, military retirements, the facts are the following: From 1971 through 1981, because of two large increases voted in, plus CPI automatic, social security for individual compounded over that period by 205 percent. Federal retirees, 176 percent during which span CPI compounded, equaled 134 percent. It is assumed that the compounding of the CPI is even more out of focus with real inflation. It did not represent real inflation because three of those years we had extremely high interest rates which under the bread basket notion of CPI made it even higher than average real wage inflation.

Now, it seems to this Senator that it is impossible for us to get the out-year growth under control without some way restraining those. I am not talking about drastic surgery, I will just give you a number. If you froze indexation, as suggested by Senator Hollings, and myself, nobody gets cut out of a check. I had a previous proposal for 3 years to take the first 3 percent of inflation and not adjust for it and give CPI less 3 for 3 years, but I will take just freezing it for 1 year. Basically, that will restrain the growth of entitlements, Dr. Galbraith, by $20 billion. If you do nothing else and let it go right back to where it was, the result of compounding diminution would save $60 billion in the 3 years. For the 1 year they would be frozen, they would be right back on CPI under that number.

Now, you indicated that you were not for any further cuts because it appeared to cause some violence out there as a social response. I submit that to this point there has been no significant reduction in entitlements and any proposal like that would indeed not be drastic but would stem the tide while we can effect this recovery.

RESTRAIN DEFENSE

Now, my concern is that I do not have your military numbers. You want to restrain the military. I just do not believe that with the gap we have we can cut defense. If that is the principal thrust of your advice to us, you may want to add monetary policy because you spoke to it for a long time, about its inconsistency, the inconsistency today. If all we are going to dramatically do is restrain defense, I submit that we probably have to do away with all the tax reductions in order to bridge that deficit gap because you cannot get those kinds of savings out of military. I gave you the numbers on growth and I could give you the 10 previous years on the trend line to where military went versus the rest of this domestic budget.

But if these are the numbers, do you still maintain that we cannot effect any significant savings in entitlements and that we must find it all in defense, change our monetary policy and raise taxes?

SOCIAL SECURITY—A CONTRACTUAL ARRANGEMENT

Dr. **GALBRAITH**. I must say that is an impressive statement, Senator. I would have to respond by also saying that in economics as in politics there are no absolutes. Professor Eckstein has mentioned one or two possible changes that could be made in social security that are obvious.

I have also had some question about the means test over age 72. The amount of the savings there are relatively small.

The question does arise as to whether relatively well-paid people should take social security regardless of their other earnings at age 72. My uneasiness develops over the fact that this is, broadly speaking, a contractual arrangement between the U.S. Government and the people and that it has come to be so regarded. People have come to frame their lives on it and particularly of course this is true of the older citizens who are limited in their alternatives. Therefore as a broad generalization I feel very uneasy about breaking that contract.

We all would agree, Senator, that the contractual relationship between the U.S. Treasury and the creditors of the Government should not be broken. I am not at all certain that the contractual relationship between the U.S. Government and aged citizens is any less important.

SOLVENT FUND QUESTIONABLE

Chairman **DOMENICI**. Well, doctor, I am going to yield to Senator Hollings but might I remind you that I do not begrudge the senior citizens the CPI and even more. I am just stating some fiscal facts about the solvency of the fund and the solvency of the U.S. Treasury in terms of being able to continue with this.

I would state to you that in the past decade if it was contractual it is amazing that Congress has taken upon itself, on at least two occasions in that timeframe, to make substantial increases. One of 20 percent. Nobody suggested that it was contractual then. The other time it voted in 15 percent, and then we went to CPI automatic. That was basically to tell you the truth. If you read the record, the CPI was built in because we were fearful that if we voted every year we would continue to go 15 or 20 percent, and this law actually reads you will get CPI unless Congress appropriates, in which event whatever it appropriates as an increase will govern.

Now, nobody wants to go back and undo the contractual benevolence that obviously occurred. I just do not know how you are going to have a solvent fund.

Let me give you one more. Do you know what percentage of the Federal Treasury is paid for Federal retirement by the workers as part of their compensation and our match? I will give it to you—36 percent payroll is what it costs for Federal retirees. The highest percent of any pension fund we are aware of anywhere. Of that, 14 percent is paid compensatory, 7 percent by them, 7 percent by us.

If you do this subtraction, the rest is paid by the general taxpayers of the country for their health program and their pension program. It is not that they earn it and take it out of their salary. It is not an annuity. I do not see how it could be contractual. It is expected, I agree, but let me tell you that those who are presently getting the benefits of our discretionary appropriated accounts, a health program in the rural areas, meals on wheels and all of those that have been cut that are on a negative 3.6 percent real growth path, expect the benefits. We have already cut that using CBO baselines; we have cut them in that manner.

Dr. GALBRAITH. Senator, I could not agree with you more completely. I came down last year to testify against those cuts, against the cuts in the food stamps, meals on wheels, in programs for families with dependent children. I think that there does develop a moral obligation. I cannot help but think that in the case of social security where people have the strong feeling that they have paid in, that it is something in which they have invested and something for which they regard as essential for the later years of their lives, this is of a different order of importance.

Chairman DOMENICI. Senator Hollings.

EXTEND 1982 BUDGET FOR 1983

Senator HOLLINGS. Dr. Eckstein, I am going to discuss the present 1982 budget and the idea that we ought to extend that same 1982 budget for 1983.

Less than 2 months ago the President signed this 1982 budget into law and we are constantly counseled by the Kemps and the Roths and the others, give it time, it is going to work, it will work, we are right on course, no retreat, and wonderful turn around, great budget 1982.

Yet you would think that that same budget would be good for 1983. However, the Treasury Department has leaked to the press the most misleading, inflammatory and inaccurate references that such a budget would wreck the economy, unemployment will go up and every drastic thing that you can imagine is going to occur in the very same budget that the administration proposed in 1982.

Now specifically, has Data Resources conducted a study of the Hollings plan?

Dr. ECKSTEIN. We have not analyzed the Hollings study itself. There is a similarity to what I present in table 4 of my prepared statement,[1] which is the benefit from a more reasonable budget.

Senator HOLLINGS. Have you run one on the Hollings plan at all?

Dr. ECKSTEIN. No, but let me make one comment on the Treasury study.

Senator HOLLINGS. All right, you make your comment and then I will make mine.

TREASURY STUDY ASSUMES REDUCTION IN MONEY SUPPLY

Dr. ECKSTEIN. The Treasury study assumes that the Federal Reserve will put out the same bank reserves with or without the Hollings plan; that then leads to a reduction in the money supply, following the basic analysis of the 1930's, if you have a more restrictive budget you have less activity. But in today's world where monetarism is the main philosophy, you have to run those solutions with the same money supply. When you do that, those Treasury results go up in smoke.

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[1] See p. 230.

Senator HOLLINGS. Those Treasury results do go up in smoke and their assumptions that there is a freeze on all programs, namely food stamps, aid to dependent children, medicaid, medicare is inaccurate, because I did not assume that. The assumptions that defense would be froze is not just in 1983 alone, but for 1984 and 1985 is incorrect. Yet this story of the Treasury study appears on the front page of the Washington Post as though it is authoritative. The Post did not even ask us anything about the program. I could have given the particular author some relevant material. It did not seem like a news column, but I wanted you as the head of Data Resources, Inc., to clarify that one thing.

Dr. Greenspan, so I will not take up too much time, I was listening this morning to you on national TV. I was very interested in your comments that perhaps if we did not see some signs of economic recovery in the next couple of weeks that we might have to change some of our projections. I understand that the average length of all recessions since World War II has been about 9 months and we are now in the ninth month here of March of this particular recession. So by the beginning of April or May we ought to have a turn in the economy and we ought to see some signs in the next 2 or 3 weeks. Is that correct, what you were saying on the TV?

Dr. GREENSPAN. I would say for the typically expected spring pick up, the data has to be clearly on hand within the next 2 weeks. We have to get some clear evidence that something of a critical nature is turning up.

Senator HOLLINGS. And if it does not turn up, other than in changing your projections around, what would you recommend?

Dr. GREENSPAN. First of all, recommend to whom?

Senator HOLLINGS. To us and the Congress right here on the committee.

Dr. GREENSPAN. Right.

RESTORE STABLE LONG-TERM CHANGE

Senator HOLLINGS. Well, to the President, too. I would like to know what you recommend to him.

Dr. GREENSPAN. The problems we are confronting, Senator, are long-term problems. I would be hesitant to fine-tune economic policy or budgetary policy to the short term. We have gotten to the point that what we have to do is restore stable, long-term growth. And I am not sure that what occurs in the next several weeks or even in the next several months should significantly alter the deliberations.

Senator HOLLINGS. I think along the line of a long-term solution, a long-term recovery. We ought to be bringing that budget deficit down from where it is in the neighborhood now of $140, $150 billion with nothing done for 1983, that we ought to be at least dramatically bringing it down to the $50 billion level for 1983, rather than just nibble off $50 billion, and leave the deficit at $100 billion, is that right?

Dr. GREENSPAN. Well——

Senator HOLLINGS. I think your answer was to bring it down to a $50 billion deficit, or thereabouts, rather than, cut $50 billion. That is what I am trying to get clear in my mind.

Dr. GREENSPAN. No, by $50 billion. I do not think we can get to a $50 billion deficit, no matter what we do.

Senator HOLLINGS. For 1983? You do not think we can do that for 1983?

Dr. GREENSPAN. No, sir.

Senator HOLLINGS. I can see one of the big reasons, the last part of your statement here, but going even further, because I was far more interested in what you had to say on TV, but if you brought it down just the $50 billion, to the $100 billion level, I think your conclusion was that that would bring interest rates down?

Dr. GREENSPAN. Yes, sir, I think the markets at this particular stage are already discounting levels of deficits not terribly different from those which Professor Eckstein is forecasting.

Senator HOLLINGS. But if you bring it down just to the $100 billion level, and programing that out to 1985, where you pick up indexing, and so forth, you are never really getting the budget back into balance, your deficits increase, it is a trend, I guess what we call here, for better description, the "glide path" that we are getting to a lower or higher deficit.

Dr. GREENSPAN. Senator, as I indicated in my opening remarks, our fiscal system is so structured that if this committee wanted to hit $100 billion in fiscal 1985, it better shoot for $50 billion. And so in that sense, using the "glide" plane analogy, you have to shoot under your target by a fairly significant amount. Whatever you set, whatever resolutions set by the Congress, they are going to underestimate the level of the deficit in the out years, irrespective of how analytically neutral, so to speak, the projections are.

Senator HOLLINGS. So you should be shooting for the lower deficits.

Dr. GREENSPAN. Yes, sir.

PRESIDENT'S PROGRAM LACKING GOOD CHOICES

Senator HOLLINGS. And therein is the dilemma of the President's program. All of us in a bipartisan fashion see it.

Let us assume that I am a loyal Reagan supporter, and I wanted to carry through his yardstick, indicate that it is a wonderful approach, and that we do something.

On the contrary, I want you to find that I have done something. Mr. Eckstein has just found a $130 billion difference in the S. & L.'s, the farm prices, the veterans costs, oil prices falling, he just listed $130 billion difference there. So does Dr. Rivlin in her presentation last week to the Appropriations Committee, another $130 billion difference, but without that difference, assuming that, and taking the President's figures, what I have had to do is cut some $30 billion out of programs, impossible to do, but I still do it, and I still end up with a $130 billion deficit. That is the problem.

He does not give us any good choice at all. It is probably worse. You projected two worst choices. One is to do nothing, and the second one is to go back on that tax cut.

But is it not a really worst choice about either of those, to actually ask us to cut some $30 billion out of programs, and still end up with a $130 billion deficit, and that is the President's program.

Dr. GREENSPAN. Well, Senator, it is an outlook which is a combination of all seemingly impossible choices, and I cannot say I find any of them particularly appetizing.

Let me just say one thing, however, which may help a little bit. I think that Professor Eckstein raised the issue of defense not rising as fast as the program numbers in the President's budget, and I think that is something that is very likely to happen. The general levels of defense outlays are undertracking the budget. There is a very interesting peculiarity in the budget figures. I am not yet clear what they mean. For the fiscal year 1982, through the month of January, we are actually running deficits well under budget projections.

There is a possibility for the first time, in a very long period of time, that we may actually end up with a lower fiscal 1982 deficit than a lot of us are now contemplating. In fact, I would suspect at this stage that we are probably running under $100 billion. So it may not be that all things are working against us. But I do agree with you, Senator, it is a very difficult problem, and I very much sympathize with your desire to get that budget deficit down. It is important for the country.

WORST ALTERNATIVE IS TO DO NOTHING

Senator HOLLINGS. Looking at the figures that the CBO presented to the Appropriations Committee, on the contrary, they show a higher deficit for 1982 going right on through to 1985, your statement, the worst alternative at this stage is to do nothing. That is to allow expenditures to move on their current services path, generating a budget deficit substantially in excess of $100 billion for fiscal 1983.

Dr. GREENSPAN. I am really citing the 1982 figures as running under the budget. But you are quite correct. Even making that adjustment, and nothing else is done, I agree that $140 billion plus for 1983.

Senator HOLLINGS. But with the President's program, assuming the action is taken by the Congress, which you go down the different chairmen on this side, because the Republicans are the majority, and they are the chairmen of the various committees, no cuts in education here, no cuts in food stamps here, and I could go down each particular chairman. Because we tried all last fall.

We were struggling to save $13 billion in budget cuts. But assuming under the CBO projections that the President's program is successful you end up with a $140 billion deficit in 1985.

Dr. GREENSPAN. Well, I think the CBO numbers are somewhat high. They are correct in saying that the President's numbers are somewhat low.

VICTORY IN TAX CUTS

Senator **Hollings**. Well, in all respect to you, and I am one of your admirers, but when you say here that to allow the individual income tax cuts currently scheduled to be delayed substantially would be a worse thing. You would rather chalk up the cuts as a victory. We should have had you around in Vietnam. We could not find anybody with the guts to call what we were doing in Vietnam victorious.

You find victory in those tax cuts, that is what has got us in this terrible mess right this minute. I mean your business world that you are right in the middle of out there, are locked in. There is no better way to say it today.

The bowels of this economy are locked, as soon as they saw these tax cuts in the out-years. There was not anything that the Congress did wrong. We did everything right, and having seen that, they say look for 1984, 1985, they will agree with you. In 1982, they are not too much worried. In 1983 they want it repaired, but looking at 1984, 1985, and then that indexing, and none of you mentioned it, and we are into that lock situation, and you want to call that victory, the very thing that got us in this particular dilemma.

TAX CUT MERELY ELIMINATION OF RISE IN TAX BURDENS

Dr. **Greenspan**. Senator, the victory that I am referring to is solving a major problem which is confronting this country; namely, a rise in the real tax burden on the individual American taypayer. To allow that to go on indefinitely would, in my judgment, have a significant effect on long-term economic prospects.

Having solved that particular problem is very important.

Now, if somebody decides that they want to raise taxes, I think that they should be put on with a recognition that they are higher taxes, and not a decision to rescind a reduction in taxes.

What is being viewed at this particular stage as a tax cut is not a tax cut at all. It merely has been an elimination of the gradual rise in tax burdens. We put into legislation last year laws which prevented taxes from rising.

Senator **Hollings**. But misnomer or not, and I understand it is a problem, I would like to reduce the Government. I would like to address the question of tax cuts, but the patient is bleeding, and it is bleeding from the loss of revenues, and we have got to stop the bleeding before we can get to the marginal problem, or to the size of Government expenditures, vis-a-vis the GNP, or to the RFC for the institutions that are failing, or for the inner-city free enterprise, or for all these particular fine programs, federalism and otherwise. We can get to those after we stop the bleeding, but what you are insisting on is let us continue the bleeding.

That is what I cannot get in through my mind, that we cannot first repair that, put on a tourniquet. Even though it might be good in other times, that is what is causing the patient to bleed to death, and to call that victory, and let us hold on to that, is a strange frustration, you see the problem, you are describing it, and I am agreeing with your description, but you would agree to its bleeding to death?

LOOK AT CORPORATE TAX STRUCTURE

Dr. **Greenspan**. If I were to look at the tax structure, I would look to the corporate tax structure, which ought to be looked at. I think there are significant revenues there, Senator.

I am not saying that one should never go back and look at it. I am saying that it is one of the very last frontiers that I would look at. If one has to start to look in that direction, Senator Dole's recommendations of recent days to replace the 1983 cut with earlier indexing, would be the type of vehicle I would support. It would at least capture the general philosophy of preventing bracket creep from occurring.

Chairman **Domenici**. I have an internal problem, since the chairman and Senator Hollings talked so much, that we ought to try this on, at the last meeting.

We will have to resolve it on a friendly basis.

Senator Gorton, you are next.

Senator **Gorton**. I want to clarify something which Senator Hollings raised. DRI, I take it, has not made a report on Senator Hollings' proposed alternative budget to see how the plan would affect both inflation and unemployment?

Dr. **Eckstein**. No, it has not.

IMPACT OF REDUCED SPENDING ON DOMENICI AND HOLLINGS PROPOSALS

Senator **Gorton**. In fact table 4 in your prepared statement,[1] with the alternatives outlined in it, are based on changes in present policy which are not dissimilar from those proposed either by Mr. Hollings or by the chairman of the committee; is that not correct?

Dr. **Eckstein**. That is correct, Senator.

Senator **Gorton**. Dr. Greenspan, could I have your comments on the assumptions, or rather the conclusions, which Dr. Eckstein makes in table 4 of his testimony as to the impact of reduced spending on something like the outline proposed by the chairman and Senator Hollings, with, of course, increases in revenues, in either the gross amounts, if not necessarily the exact pattern of Senator Hollings, or in the slightly more modest amounts suggested by the chairman.

Dr. **Greenspan**. Senator, it is difficult to evaluate output of a model without looking at some of the details. There is one implicit assumption here which I think we had better be very careful that we make very explicit, and that is the presumption that increased revenues, on net balance, reduce the deficits. Over the long run it is becoming ever more clear that the level of outlays is affected by increased revenues and that a shortfall of revenues is one of the reasons why the level and growth of expenditures has slowed down. As a consequence, that any attempt to influence revenues has to be crafted in a very careful manner because what you end up with is not a reduction in the deficit but merely an increase in both revenues and expenditures. This sort of evaluation, does assume that there is no relationship between receipts and expenditures in the political sense. As a result you get significant reductions in the deficit and significant softness in interest rates and therefore increases in real GNP.

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[1] See p. 230.

I do think that it after the fact that the deficits are lower and, more importantly, that the long-term projected deficits are lower, that long-term interest rates will fall and that these types of consequences, plus or minus, are likely to prevail.

DEFERRING OF TAX REDUCTIONS

Senator **Gorton**. I was impressed by a great deal of what you had to say in your formal statement. I must confess however that to a certain degree you lost me in your answers to the chairman's questions and so if I can I am going to try to reconstruct what I understood your message to be and ask you about the consequences of that message.

You did recommend severe reduction in the growth of the defense budget on the grounds that not only was it appropriate in and of itself but because it would reduce deficits and that we needed to reduce the huge deficits with which we are faced.

I believe in addition, however, in answer to the chairman's series of questions, you stated that you felt that the present system under which entitlements are changed automatically each year was in the nature of at least a quasi-contract with beneficiaries and should be changed to their disadvantage only with the great reluctance, if at all. And in the following up on another of the questions of the chairman, you stated that a number of the social programs which are not entitlements but which are simply the subject of annual appropriations, at least fell into the expectancies of their beneficiaries and of the American people as a whole and that in fact last year you made a recommendation against cuts in many of those programs.

Now, you also recommend, as I understand it, that something like which Senator Hollings has proposed, a cutback, if not a cancellation of the individual income tax cuts due this year and an ending of tax indexes. As I read Dr. Greenspan's testimony, and I think the conclusion is inevitable, if we should follow such a course of action indefinitely we would have approximately a 1-percent increase in the percentage of the gross national product which was taken by the tax system each year because of inflation.

Is it your position that that kind of constant increase in the real level of taxation in the United States does not offend against any expectancies or any kind of quasi-contract with the American people and/or that it has no adverse impact on the economy and on economic growth?

HIGHER TAXES VERSUS HIGHER INTEREST RATES

Dr. **Galbraith**. I would not for a moment, Senator, regard that as a contractual matter. There is nothing to which the American people are more accustomed than movements in tax rates up and down. And I would not make any comparison between that and the expectation of people in their earning years as to what they will get when they retire. I do not think there is any parallel there at all.

As to increases in taxes, like everybody else on Earth, I could make speeches against increases in taxation but the point that I would like to insist on in the strongest way is that when you have a choice between higher taxes and higher interest rates, every person, including every person who has some association with the American business community, should take the taxes rather than the interest rates. The interest rates are far more damaging to the economy and far more damaging to business and therefore far more episodic and discriminatory in the way they hit different kinds of business than is the tax system. Therefore facing the choice which my friend Alan Greenspan is so artfully ducking as between a higher deficit, a monetary policy and higher interest rates on the one hand, and deferring those tax reductions on the other, I would strongly urge the deferring of the tax reductions and I would do that while putting on a mantle of conservatism that would surprise everybody here in this room.

Senator GORTON. Mr. Chairman, may I ask Dr. Greenspan and Dr. Eckstein if they wish to comment on the last question?

Chairman DOMENICI. Yes.

CURTAIL GROWTH OF EXPENDITURES

Dr. GREENSPAN. The basic problem I have on the tax side is what I have just outlined. The general problem is that we have got to curtail the growth of expenditures.

If you start off with the presumption that you are going to start by increasing real tax burdens as a solution to this problem, I fear that what will end up with at the end of the deliberations is increased expenditures and the attempt to reduce the deficits from the tax side will in fact turn out to be futile. I am not saying that under no conditions would I contemplate the issuance of changes in taxes but under no conditions would I want to contemplate increasing taxes which do not have dollar for dollar declines in the deficits. And I am concerned that we will end up at the end of the process with higher taxes and higher spending and very little reduction in deficits.

Senator GORTON. Mr. Eckstein.

LINK FROM REVENUE TO EXPENDITURE ABANDONED

Dr. ECKSTEIN. I will be brief.

What went on with the budget in the last 15 years was wrong. We needed personal tax reduction. But where we went astray was in what Dr. Greenspan enunciated. We abandoned the link from revenue to expenditure. It is true if you deprive the Federal Government of resources it will spend less. But they are not going to do that in 1983 or 1984 or 1985 either. They are going for these enormous defense appropriations despite the tax cuts. And we simply overcut. We gave away more money than we had. It was wonderful to do it and we enjoyed it but you cannot do that with the kind of rearmament in which we are engaged and yet receive a sensible result. It does not add up.

Senator GORTON. Thank you, Mr. Chairman.

Senator DOMENICI. Senator Moynihan.

ECONOMIC DISASTER—A FULL SCALE DEPRESSION

Senator **Moynihan**. I would like to proceed from Dr. Eckstein's comments here.

May I first thank the panel for restoring economics as the dismal science and to tell you that you have done us more service than you might have thought. A year ago a program was offered in this city based on the view that economics is simple, that there would be no difficulty with revenues, and that anyone who did not know that had rightfully lost the last election. In May 1980, the President in Flint, Mich., put it all in one sentence. He said, "We will take the increased revenues that come from the decreased taxes and use that to build up our military defense."

That is certainly an agreeable thought, and heaven help anyone in those days or even last year who thought it might be more cumbersome. In fact, the choices, as Alan Greenspan has properly put it, are usually between bad alternatives and worse ones. I would like to ask the panel about that in a moment.

Some of you may have seen the article in Fortune entitled "The Stockman Recession," by Paul Craig Roberts, who until very recently was Assistant Secretary of the Treasury for Economic Policy. He resigned in December. And yesterday in the New York Times, a great and powerful article by Benjamin Stein appeared called "A Scenario for Depression," describing how he thinks it could proceed from our present conditions, how one goes from the conditions of past recessions into a genuine crash—something about which Professor Galbraith has written. I note, both Professor Galbraith and Professor Eckstein end their testimony with the word "disaster."

You spoke, Mr. Galbraith, of potential disaster. Mr. Eckstein spoke of budget disasters. I wonder if I could ask you, supposing the administration does not change its course, and Congress does not agree to further cuts, what would you say is the probability that we will be moved from this recession to a genuine economic disaster, a full scale depression?

Professor Galbraith, you wrote the book on the Great Crash. Perhaps you could begin.

HIGH INTEREST RATES OR SEVERE INFLATION

Dr. **Galbraith**. Well, one should always recur on these matters to Adam Smith, who was once asked for his view of the prospects, someone having said that he thought the Nation was ruined.

Senator **Moynihan**. There is a good deal of ruin in a nation.

Dr. **Galbraith**. There is a good deal of ruin, was, indeed, his reply. One of the problems in appearing before this committee is that you have Senators who are far more learned than the witnesses.

There is a good deal of ruin in a nation, and because Professor Eckstein and I have used the term "disaster" too loosely, if this budget continues to the best of one's estimates, we shall have either a rigorous monetary policy with very high interest rates to offset it or alternatively, the Federal Reserve will ease off on interest rates and we will have a recurrence of severe inflation. We will have one or the other. That is why we are engaged in this discussion here this morning and it is why I would much prefer higher taxes—a deferring of the tax reductions—to either the eventuality of high interest rates or the eventuality of returning to a high rate of inflation.

Dr. ECKSTEIN. To get a depression in this country I think takes three things, and I do not believe that it is very realistic that we get all three.

The first is we need this continuing budget, the prospect of $130 billion, $140 billion deficits forever.

Second, we need a Federal Reserve willing to accommodate any of it, that they will stick to monetarism with 3 or 4 percent money growth.

And finally, what you need is a set of financial disasters, which the Federal Reserve refuses to deal with.

The last of these three things, I think is the least plausible. The Federal Reserve has been skillful in handling all the bankruptcy problems that we run into.

So unless we suspend all commonsense, we are not going to get a depression. We do have an administration in which the President is his own economist. I think that is pretty evident and you just——

Chairman DOMENICI. I did not hear that.

Dr. ECKSTEIN. We have an administration in which the President is his own economist. He rejected the advice of virtually everybody around him and we do not know how good an economist he is so we do not know what the reaction would be if we got in deep trouble. Maybe it would be effective and it would not. But it is alarming that for the first time in many decades the basic administration policy flies in the face of the entire conventional wisdom of an enormous spectrum of opinion and, indeed, it is.

Chairman DOMENICI. Would you like to comment, Dr. Greenspan?

It is now my time. Your time has run out.

Senator MOYNIHAN. How much does that light bulb cost?

Chairman DOMENICI. Go ahead.

Dr. GREENSPAN. I will answer quickly.

I think the possibility of a depression is very small, period.

NUMBERS BASED ON CBO BASELINE

Chairman DOMENICI. All right.

Senator Boschwitz, before you start, could I clarify the record?

My numbers, so that if you are going to go back and check them or somebody is for you, that I gave you, are based on the CBO baseline, all of the reductions that we made in reconciliation plus the Omnibus bill, the percentages I gave you are from the CBO baseline. I think Senator Hollings, when you referred to CBO's additional $130 billion, that was with reference to the President's $92 billion, or whatever his was. They said $130 billion. It is the new $130 billion, is that not correct?

Senator HOLLINGS. Actually $121 billion. There is that chart and I can give the exact figure of 1983, where he is assuming a $91.5 billion. They assume $121 billion and in 1984 where the President assumes $82.9 billion, CBO assumes $129 billion; and in 1985, where the President assumes getting down to a deficit of $71.9 billion, CBO assumes $140 billion.

Senator DOMENICI. Thank you very much.

Senator Boschwitz?

INCREASING REVENUES DOESN'T NECESSARILY DECREASE DEFICITS

Senator BOSCHWITZ. I agree with Dr. Greenspan that increasing the revenues does not necessarily decrease the deficits. As long as I have been on this committee, for every dollar taken in we have spent $1.15. Unless there is some reduction in revenues there does not seem to be a reduction in outlays.

Also I agree that lowered tax rates do not necessarily bring about smaller revenues as evidenced by the 1964–65 cuts and by the reductions in capital gains rates which brought about more investment.

So I for one will not vote on this committee or in the Senate to change the Kemp-Roth schedule that has been established unless there are very meaningful offsetting reductions in spending and even then I would do so very reluctantly.

I agree with Dr. Galbraith that the principal thing that is affecting our economy are the enormous interest rates.

IMPACT ON INTEREST RATES IF BALANCED BUDGET ADOPTED

I would like to ask, and would ask each one of you to briefly respond. Suppose that this committee adopts a budget, whether it be the Hollings plan, the Domenici plan, the Gorton plan, the plan that I have put forward or another that shows that we will balance the budget by 1986 and come close to a balance by 1985.

What would be the impact on interest rates in the short term, say 6 months and a year from now, in the event that we adopt a budget path that brings about a full balance by 1986, and close to a balance by 1985; and that is accompanied by the authorization changes necessary to implement the spending reductions. I ask that you answer briefly in the turn that you testified: Dr. Galbraith, Dr. Greenspan and then Dr. Eckstein.

FALLING INTEREST RATES AND ECONOMIC EXPANSION

Dr. GALBRAITH. Well, Senator, I venture to think that you have locked yourself into a contradiction here.

Surely if the budget were passed without reference to individual items but so that it accords with respective revenues, we could certainly count on a reduction of interest rates, responding investments and a substantial response in the economy. But that evades the whole question of where we cut. It would mean heavy cuts in the social expenditures, further on top of those last year, heavy cuts in the military budget and severe cuts in the entitlements, some cuts in things which would not be overwhelmingly popular in your State in the farm budget.

Senator BOSCHWITZ. Doctor, I did not ask if they would be overwhelmingly popular in my State.

Let me repeat the question and ask you to be very direct in responding to it.

Dr. GALBRAITH. Senator, I am being extremely direct. The directness should not permit error.

Senator BOSCHWITZ. Directness what?

Dr. GALBRAITH. I say I am being exceedingly direct. I am only saying that directness should not prevent description of what the true problem is.

If you are willing to abandon Kemp-Roth; permit suspending the tax increases, thus freezing them as Senator Hollings has proposed, and then take enough out of the defense budget, enough out of the entitlements too, enough out of the social expenditures to make a balanced budget, I have no doubt that the interest rates would fall dramatically and that the economy would expand.

I regard interest rates as a far more depressive influence on the economy than taxation. To repeat myself once more.

Senator BOSCHWITZ. Dr. Greenspan?

ECONOMIC RECOVERY IN INTEREST-DEPRESSED AREAS

Dr. GREENSPAN. First, it is important to ask whether or not the resolutions of the Congress are credible in the sense that the markets believe them? If it is strictly an increase in taxes, my suspicion is it will not. If it is a combination of further cuts in expenditures which are constrained by legislation and in a manner which are not easily altered, coupled with some revenue increases, the markets probably will believe them and long-term interest rates would fall almost immediately. The consequences of that would be a decline in short-term rates and a significant recovery in interest-depressed areas of the economy.

Dr. ECKSTEIN. If the Reagan program is scaled back to realistic dimensions, somewhat less defense and somewhat less personal tax cuts, but still enthusiasm for other cuts, then the program will succeed. It may not succeed as fully as the early projections indicated but you will get restoration to a higher trend, better productivity performance, you would be turning the corner as people's hopes were raised a year or two ago.

So the opportunity is there and it is really a tragedy that we are in danger of throwing it away by excess.

STAYING WITHIN BUDGET IMPRESSIVE TO FINANCIAL COMMUNITY

Senator BOSCHWITZ. In the event, Dr. Greenspan, we accompany our budgetary path with the reconciliation institution and stay within our proposed budgetary framework do you think that the folks in the financial community would and would we see a change in interest rates fairly quickly?

Dr. GREENSPAN. If they believed it. There is always the problem that there is a second budget resolution, a third budget resolution and Lord knows how many other numbers after that. It is that problem which continues to concern not only Wall Street and the financial community, but the Nation as a whole in its financial affairs.

If you could somehow construct something and hang in there with it, I think yes, the market's reactions would be very impressive.

Senator **Boschwitz**. I seem to have run out of time, Mr. Chairman.

Chairman **Domenici**. Let me suggest, Senator Boschwitz, you might not have taken very much time but the questions and answers are very important, and I thank you for raising them that way.

HIGH INTEREST RATES ARE PRINCIPAL ECONOMIC PROBLEM

Senator **Boschwitz**. I think the principal problem we face in our economy is the high interest rate. I feel it every day in my business. As Dr. Greenspan pointed out, the February figures are not particularly good. I receive my own figures every 2 or 3 days. Without question, I feel very strongly that this committee has to take some action and show some leadership that will convince the financial markets and that will be over the broad spectrum of the budget. I certainly will support such initiative.

TAXES AND ENTITLEMENTS MOST CREDIBLE

Chairman **Domenici**. I might suggest, Dr. Greenspan, your continual use in your response, if it is credible, has become very important to this Committee. We are fully aware that there are certain changes that lead to conclusions that are credible and there are certain changes that do not. I would submit to all three of you that the two that are most credible are entitlements which once changed are simply a subject of extrapolation and taxes. The discretionary appropriations are subject to veto every year as they come out. The tax end and the entitlements are the most credible part of the equation. There is no doubt about that and I think everybody on this Committee has found that out.

Senator Johnston?

Senator **Boschwitz**. Would you yield for a moment, Senator?

I think the attitude I see in the Senate, on this committee and pointed out by Dr. Galbraith is credible. We have to do something and by George, I think most of us intend to.

PRESIDENTIAL LEADERSHIP NEEDED

Senator **Hollings**. And one other observation to emphasize what Dr. Eckstein said, that you have never seen a Congress in and of itself enact these things. What we need is the Presidential leadership.

On this side of the aisle, Senator Boschwitz, we have many persons willing, ready, and able. Senator Baker is running around trying to get the Senate on TV. I am running around trying to get a secret ballot. If I could get a secret vote on my plan, I could get 80 Senators right now to vote for it. But without the secret ballot and without the Presidential leadership, the average fellow on this side of the aisle says yes, I can go along with it, but I am going to be tackled from behind, I am going to be posturing myself against defense and social security. I am not getting out on that limb.

We are not making good progress. We are sounding good to each other but the quid pro quo——

I yield.

GIVE MARKETPLACE SOMETHING CREDIBLE TO BELIEVE IN

Senator JOHNSTON. Mr. Eckstein, have interest rates, real interest rates ever been this high before; that is, the difference between inflation and interest rates, particularly long-term interest rates?

Dr. ECKSTEIN. They have never been this high for more than a month or two and that goes back to before the Civil War.

Senator JOHNSTON. That would suggest that there is an element of psychology, predominant element of psychology involved in the long-term interest rates, would it not?

Dr. ECKSTEIN. Yes, sir.

Senator JOHNSTON. And one that could be reversed as Mr. Greenspan says very rapidly if you could just give them something credible to believe in, give the marketplace something credible to believe in, interest rates would come down rather immediately, would they not?

Dr. ECKSTEIN. Well, the immediacy question is a little more debatable because the bond market is really demoralized and the professional bond managers have taken such a licking in the last 2 years, having lost much of their capital, let us face it, once, twice, it would take a long time before they persuade their bosses to go big on bonds. I think it will take, despite the bond prices, I think it will take some time.

REDUCING DEFICIT WOULD LOWER LONG-TERM INTEREST RATES

Senator JOHNSTON. Let us say we cut $50 billion, which I think is credible, as Senator Hollings is talking about, about more, Senator Domenici is talking about more but if we should cut $50 billion, do it in a convincing way, in your view what would long-term interest rates come down to? I am thinking of housing mortgages more than anything else.

Dr. ECKSTEIN. We have studied that with our models. An improvement in the deficit would lower bond yields by 1.5 to 2 percentage points according to our admittedly somewhat iffy calculations.

Senator JOHNSTON. Dr. Greenspan, what would you think of the amounts by which long-term interest rates, particularly housing, mortgage interest rates would come down if we would cut $50 billion from the deficit?

Dr. GREENSPAN. 150 to 200 basis points. I think it may be more in the mortgage markets, because if it is associated with the decline in short-term rates, you would find, instead of having savings and loans setting their commitment rates on mortgages at levels which they hope will not be hit, because they do not have the money to give out, they will look for business and mortgage rates would probably fall somewhat further than bonds.

Senator JOHNSTON. Well, at 150 to 200 basis points, that would still put them at historically high levels, the difference between real interest rates, would it not?

Dr. GREENSPAN. That is correct. But I think that we are in an area where every percentage point, or 100 basis points, makes a big difference for housing.

MARKETS ASSUMING LONG-TERM RATE OF INFLATION

Senator JOHNSTON. Why would not these long-term rates come down to historic levels, if we gave the convincing demonstration that we have reduced the deficit?

Dr. GREENSPAN. Because I think that the markets at this particular stage are assuming a long-term rate of inflation, which approximates 10 percent. They have been so demoralized, as Dr. Eckstein has indicated, that there is a sense in which relief will be coming a little more slowly than it usually is.

Eventually, if the budget deficits are brought down to credible proportions, or are no longer rising, and the fiscal system is in shape, so to speak, then I think that rates will retreat all the way back down to where they used to be. There is nothing in the system that I am aware of, which says that we cannot go back to interest rates which prevailed in past generations.

CHANCES OF DEPRESSION OR RECESSION

Senator JOHNSTON. All right.

Doctor Eckstein, I was interested in your projections of where we are going from here, in your confidence levels, and probability distribution, and those kinds of things. Do you see it very improbable that we would have a depression, as you would define a depression?

Dr. ECKSTEIN. We think there is only 1 chance in 50, or 100, that this could occur within the next 4 or 5 years.

Senator JOHNSTON. Do you concur with that, Dr. Galbraith?

Dr. GALBRAITH. I think I would leave those predictions to my better qualified colleagues, Senator. I am not in possession of an economic model. They are.

One could put together a set of circumstances that would give that result, but——

Senator JOHNSTON. Like the Reagan budget?

Dr. GALBRAITH. Like the Reagan budget. I think economists in my position, without the support of an econometric model, make these predictions, not because they know, but because they are asked.

Senator JOHNSTON. Well, frankly, I think there are a number of us on this committee who fear, if not depression, then a recession of a depth and brilliance that we have not had in modern times, and one that would be very difficult to get out of, and I think that is the only reason that a number of us are considering the Hollings or the Domenici plan. This is terribly difficult politically, but it may be acceptable only because the risk is so great of acute economic distress. If the risk is not that great of acute economic distress, then I for one do not want to take the bitter pill.

Are you saying that the risk of acute economic distress, is not that great, or that of simply depression is not that great?

Dr. GALBRAITH. What I am saying here, Senator, is that the one thing we know is that there is a gamble in these very, very large deficits, and they have in turn the effect of forcing either a high rate of inflation or a strongly powerful restrictive action by the Federal Reserve. This is a risk which we should avoid.

I talked the other day with a longtime member of earlier administrations, a strong supporter of the President, a one-time Ambassador, who is very active in Wall Street, and I was taxing him with the risks that are involved. He finally said to me, "Well, look, Galbraith, there is 1 chance in 10 that this might work, and I am for it."

Now, that involves an attitude on economic policy which is inconsistent with the defense of anything that is as important as the American economy.

Senator **JOHNSTON**. Is he not the one who said we have only one economy to gamble with?

Dr. **GALBRAITH**. No, I said that.

Senator **JOHNSTON**. Oh, you did?

My time is up. Thank you, Mr. Chairman.

Chairman **DOMENICI**. Senator Kasten?

PRESIDENT'S ORIGINAL TAX PROGRAM

Senator **KASTEN**. Mr. Greenspan, one of the principles that we have been working under for the last year is that money should be relatively tight in order to bring down inflation. The negative effect of that tight money policy would be offset by the positive effects of the marginal tax reductions.

Now, money has been tight, more or less, but taxes are still high. I think that is one of the points you were making, although maybe not as strongly as I would like. This year the Government is going to take in 20.3 percent of GNP in revenues, compared to 19.1 percent in 1977.

The fact is that we did not get the tax cuts we wanted. The tax cut was 5 percent instead of 10 percent, and it has been offset by bracket creep for most families.

So this hemorraging, or drain of revenue is not there. Taxes are higher this year than last year.

In your opinion, if the President's original schedule for the tax cuts were in place, would we be better off now than we were? What do you think of undoing some of the damage caused by delaying the tax cut by accelerating the third year from July to January 1983?

But, first of all, would we be better off if the President's original program were in place with a 20-percent cut in our marginal rates today, March 1982?

And second, would we be able to improve ourselves by speeding up that January 1983?

TAX BILL AS PASSED IS WORKING

Dr. **GREENSPAN**. I would say no to both questions, Senator. The major improving of savings incentives in the Economic Recovery Tax Act of 1981, so far as individuals were concerned, occurred as a consequence of lowering the high marginal rate from 70 to 50 percent, and the basic improvements that that implied with respect to the capital gains tax.

A lot of very valuable effects would eventually occur as a consequence of that. Aside from that, I think that the tax actions that were taken, are important, because they prevent that extraordinary rise in total receipts as a percent of GNP. It is very important that we try to stop that from occurring. We have the characteristics of a Greek tragedy in which we cannot seem to prevent an ever increasing share of the national income going to Federal taxes. The tax bill that was passed last year, and in place, does what I in fact would like to see done. I am not sure that the increasing deficits that would occur as a consequence of accelerating the rate cuts, actually are a plus.

I am always in favor of cutting taxes, but in this instance, we have a very difficult problem with respect to financing, and I would be inclined to say no.

Dr. GALBRAITH. You would extend that logic to deferring the tax increases?

Dr. GREENSPAN. Not necessarily, because it presupposes that the more one moves in one direction, the better, and I am not agreeing to that.

Senator KASTEN. We are not in trouble because of spending, we are in trouble because of a recession, that is our problem. We are in a position where, as you pointed out, we have Federal tax receipts at 20.3 percent of the gross national product, compared to the Carter estimate of 21.1 percent. We have Federal expenditures from the Carter peak of 20 percent in 1980 to 24.4 percent in 1982. That is what we are projecting in our own budget book.

Now, it seems to me that the talk here this morning is to increase taxes still further in order to balance the budget, and to bring down interest rates.

We tried that last year, and the result is a recession.

Dr. GREENSPAN. Is that addressed to me?

Senator KASTEN. Yes.

RECESSION IS CONSEQUENCE OF HIGHER INTEREST RATES

Dr. GREENSPAN. The recession is a consequence of higher interest rates, and they in turn are a consequence of the financial markets presuming a rise in Federal deficit financing and inflation, which are very high levels.

Senator KASTEN. Mr. Chairman, my time has expired, but if the other two would like to comment on that question?

Chairman DOMENICI. Yes.

Dr. ECKSTEIN. I do not want to reopen all the debates of Kemp-Roth. I do not think one should evaluate it as all or nothing.

But it is whether the total magnitudes were right. In the short term, whether the tax cuts should be accelerated to fit the session, I am opposed to that. If we need more stimulus, for whatever reasons, including spontaneous weakening from here on out, the way to deal with it is to bring interest rates down. To fight it with tax cuts will simply compound the financial problem.

Furthermore, in terms of the 1982 acceleration, it is too late anyway. If you were to accelerate those reductions, you would not get them done before May or June. And even for 1983, the enlargement of the 1983 deficit created by acceleration with present monetary policy would only compound the whole financial squeeze.

DEFICITS VERSUS DEFENSE SPENDING

Chairman DOMENICI. Let me give the three of you a quick analysis of the deficits versus defense spending, because I think there is a growing tendency to assume we solve this problem of high interest rates resulting from the expectation of high deficits by cutting military spending.

Now, remember that if we do nothing with the domestic nondefense side of this budget, it will be growing between 10.5 and 11.5 percent, automatic and compounded. If we do nothing there. These are the facts.

Using CBO, not the President, the 1982 deficits are $110 billion; 1983, $166 billion; 1984, $205 billion; and 1985, $239 billion. That is assuming no further reductions, as I just described it, and full military funding and tax cuts in place.

So we will put the tax cuts into perspective. Let us list them right under that total, total reductions. In 1982, it is not any monstrous tax cut. The Senator is absolutely right. It is $38 billion. In 1983, it is $92 billion; 1984, it is $139 billion; and in 1985, it is $177 billion.

Now, if you want to take all the tax cuts out, the remaining deficits are $72, $74, $66, and $62 billion, respectively. This Senator did not suggest that at all, but I wanted to put it in perspective. If you start with that premise, this is what you get.

If you want to get all that out of the President's Defense budget, you will reduce the Defense budget by the following percentages: 38 percent in 1982, 33 percent in 1983, 26 percent in 1984, and 21 percent in 1985.

Now, I submit there are, talking about consensus, not 10 people around who studied that defense budget who think it can do that. All this leads to the conclusion that if you want to leave substantial tax reductions, even those that are just business, which everybody assumes that you have a change in the depreciation schedule, there is no way to move that trend line dramatically, as all of you suggest. To move the trend line of the deficit, downward realistically, and credibly by just saying we are going to look only at taxes at the defense end of this budget. It is an economic impossibility, and from the standpoint of the practicalness, it will not fly.

I think it is enormously risky to assume you can do that with the defense budget of the country. So I just want to put that in perspective, to give one who suggests that everything is hunky-dory, just cut defense and change the tax laws. You will be back where you were, getting rid of old taxes on an accelerated basis on individual and businesses, instead of a Domenici one, and you can cut defense to a point, but I do not think anyone assumes you can take 38 percent out of 1982, 26 percent in 1984.

These, again, if anyone wants to change my numbers, are not the President's, they are not his estimates of spendouts. They are CBO's baselines in all respects.

I would be pleased to yield to Senator Hollings.

FREEZE WILL CREATE BETTER AND STRONGER DEFENSE

Senator HOLLINGS. Let me, before thanking, because that is what I wanted to do, but since the distinguished chairman mentioned the defense budget, I have been working for 10 years in that particular field. My recommendation of a freeze is not a flip or casual recommendation. The great need at the moment is not money, but time, and deliberate consideration of the kinds of defense, and the awarding of the contract, and procurement of contracts in the context of a general plan for that kind of defense.

This is the first administration that has yet to place before us what we call our 5-year procurement annex, so that we can just put up that wide sheet and look ahead and see where we are 5 years from now. We are going , willy-nilly down the road, like a kid in a candy shop with backed up money. We have an unobligated balance of $33.8 billion this year, and if you grant the President his defense figure, you will have $20.1 billion. The money is piling up.

There is no oversight, there is tremendous waste, and I am confident we can get, a better and stronger defense for this freeze, and with a deliberate oversight, and a phasing in over 36 months, rather than 24 months, the $55 billion. We added $24 billion last year, we are adding $34 billion this year, and a deliberate phasing in will give us that stronger defense.

There are all kinds of ways. I will present a studied authorized, and verified approach. The Secretary of Defense says it is totally ridiculous. Everything I say is totally ridiculous. I must be better than Mark Russell. I am abusing them all better.

But you can forestall the one, the main one, which you cannot afford at this period of time for $40 billion, allocate those funds over to the readiness amounts, and come up with 5 percent real growth in 1983, and 5 percent real growth in 1984, and 5 percent real growth in 1985. That is about the best you can do.

So I sense the distinguished chairman was commenting on the budget, and giving us the figures, I will give you the charts and show you how you can do it as a pro defense Senator. Please, let me thank all three of our witnesses.

This is one of the best panels we have ever had, and I agree particularly with the concluding comments from all three witnesses here. The problem is the deficit, Senator Kasten. This is what we heard from the CBO, this is what we hear from the panel, it is not recession induced. We have to agree what the problem is in the first instance. Like Alice in Wonderland, we first have to decide where we are, and I think the three of them agreeing on where we are is very, very important.

I thank you.

Chairman DOMENICI. I thank you, Senator Hollings.

My numbers did not intend to be an extrapolation of your proposal, just applied percentages.

I want to thank the panel. I think, considering your diverse views, you have done us a service, and the country a service.

Thank you very much.

[Whereupon, at 12:38 p.m., the committee adjourned, subject to the call of the Chair.]

VIEWS OF THE CHAIRMAN OF THE FEDERAL RESERVE SYSTEM

TUESDAY, MARCH 2, 1982

U.S. Senate,
Committee on the Budget,
Washington, D.C.

The committee met, pursuant to notice, at 10:09 a.m., in room 6202, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Armstrong, Kassenbaum, Boschwitz, Hatch, Symms, Gorton, Hollings, Sasser, Hart, Riegle, and Exon.

Staff present: Stephen Bell, staff director; Gail Fosler, chief economist; Lizabeth Tankersley, minority staff director; and Kemble Stokes, chief economist for the minority.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Chairman Domenici. The hearing will come to order.

Chairman Volcker, it is a pleasure to welcome you to the Budget Committee. I have been reading your remarks in your various appearances here in Congress and in public speeches before various business groups and associations. I must say that you spend as much time talking about the budget as we do, and it's not even your job, but we here on the Budget Committee do appreciate the help.

As you are so keenly aware, the Budget Committee is facing a very difficult task. We expect to begin marking up a first budget resolution in 3 weeks. It will not be easy, and our differences among the members are still substantial. Nevertheless, I am confident that this committee can come up with a bipartisan compromise which will be a responsible recommendation to the full Senate.

I believe that we have the outlines of a plan, at least the first parameters. We all understand that the final solution must address every aspect of the budget, and must be fair and equitable in the burdens it imposes upon the American people. However, such a plan also has to have some promise of relieving the burden of high interest rates, and concern among Americans, which quite frankly borders on panic, about our economic prospects.

"GARDEN HOSE VIEW"

You are no stranger to difficult jobs, Mr. Chairman. Yours is one of the toughest. Controlling the money supply is complicated by many technical factors which cause extreme volatility from time to time, particularly when the economy itself is changing rapidly as it has in recent months. Many fairly sophisticated observers of monetary policy have what I call the "garden hose" view, that money flows out of a spigot at the Federal Reserve, which can be turned from a roaring spray to a bare trickle with just a simple twist to the handle.

That is simply not the case. I think that in a country of 200 million Americans who spend and save, who make decisions on whether to hold their money in cash or in money markets, who deal with complex financial structures and a most complex tax system, it is amazing that you have been as successful as you have in controlling both the growth and the variability in money supply.

FIRST TASK IS REDUCE BUDGET DEFICITS

As you can plainly see from my statements, Mr. Chairman, I do not view high interest rates as a purely monetary phenomenon. Budget deficits are projected to be high and the expectation is that this economy cannot function indefinitely with real interest rates at current levels. Large budget deficits mean either high interest rates or high inflation. I cannot see it any other way. So the first task is ours, Mr. Chairman, to reduce the budget deficits.

I will say, however, that substantial action on the budget will not come without the promise of success. I would hope that in response to congressional actions to reduce the prospective deficits, in a clear pattern toward balance, that we could be assured that the Federal Reserve would adhere to its monetary aggregate targets and, if it errs, it will err on the high side of the target. Reductions in the deficit alone could well have adverse impact on an already weak economy. Deficit-reducing actions, which are a bitter pill to many, must have their counterpart in a prudent response.

I welcome you here this morning, Chairman Volcker, as a man with a difficult job. I am hopeful that this committee can make your job easier. If we can bring down the size of the budget deficits, the Federal Reserve's task, to control the growth in the money supply, should be an easier one. I hope that you will give the committee your thoughts on the deficit targets that we should aim toward, the general outlines of a plan to reach these targets, and some guidance as to what we can expect from interest rates and monetary policy in the event that Congress adopts such dramatic action.

NUMBER OF PROPOSALS AROUND

I hope that you are aware of the President's proposal, at least in general terms, what his deficit would look like, and what he would do with the tax structure of the country by way of revenue changes.

I know you are aware of the fact that there are a number of proposals around. Senator Hollings has put forth one; I have put forth a combination of what I said last year with a few changes that I have found to be more acceptable to some people than what I suggested last year.

Generally, we would like to know from you what your views are on why interest rates are so high and why they have remained so high, what you recommend in order to bring them down, and what you think about various proposals in terms of the opportunity that they provide for interest rates to come down.

With that, we are going to try to let you tell us as much as you want and then spend some time asking you questions.

I yield to Senator Hollings.

Senator **HOLLINGS**. Thank you, Mr. Chairman.

I welcome you, Mr. Volcker, and will be glad to hear from you, sir.

Chairman **DOMENICI**. Does any other Senator have a few remarks?

Senator **RIEGLE**. Why do we not go ahead?

Chairman **DOMENICI**. All right. Chairman Volcker?

STATEMENT OF PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. **VOLCKER**. As you pointed out, Mr. Chairman, I have been appearing before Congress and elsewhere talking about this range of problems for some weeks, and perhaps I can just read portions of my statement, which contains, I think, some rather familiar material.

In my statement, I note that the potential problem before us lies squarely at the intersection of monetary and fiscal policy and of our respective responsibilities. My statement first reviews the monetary policy problem.

UPROOTING INFLATIONARY PROCESS IS DIFFICULT

Monetary policy has, of course, been directed toward restraining growth in money and credit, with the important objective of reducing inflationary pressures and placing the economy on a course toward price stability. The hard fact is that uprooting a deeply embedded inflationary process is difficult. It is made even more difficult to the extent the effort is concentrated on one policy instrument.

The fact that interest rates have remained painfully high in the midst of recession, restraining activity in credit-dependent sectors of the economy, is one reflection of the difficulty. But the problem extends back over a number of years. As you know, the current recession has been superimposed on a pattern of stagnation extending over a considerable period.

I do not think there is any great mystery as to why the economy has behaved this way. Beginning in the mid-1960's, inflation increasingly became a way of life and, in the process, distorted economic incentives, sapped our productive energies, and caused arbitrary and capricious transfers of income.

For a time, as inflation gained momentum, real interest rates were low or negative. But after inflation took hold and became embedded in behavior and expectations, anticipations by borrowers and lenders alike tended to propel interest rates higher. And as monetary policy moved to deal more forcefully with the inflation, particularly in the context of fiscal imbalance, the strain on financial markets became more acute.

The alternative course of simply accommodating inflation by providing it monetary sustenance would, however, offer no lasting relief. By feeding expectations of inflation and reinforcing the reluctance of lenders to commit funds for any but the briefest periods of time, the high level of interest rates, and particularly long-term rates, would only become further embedded in the economy.

MOST IMPORTANT FINANCIAL YARDSTICK LOST

The hard fact is that loss of our most important financial yardstick—a stable dollar—bred high and volatile interest rates. Restoration and maintenance of lower interest rates is ultimately dependent on greater confidence that stability can and will be restored.

I review in my statement the in very summary fashion the growth of the aggregates and interest rates last year. Let me summarize by saying that characteristic of the past year has been a persistently high level of intermediate and long-term interest rates—an area of the market most heavily affected by expectations.

Those interest rates have remained high despite visible progress, and potentially lasting progress, on the inflation front. To be sure, some of the progress against inflation reflects the more immediate and potentially reversible effects of recession-weakened markets, current surpluses in petroleum and grain production, and reduced commodity speculation and pressures generally for inventory liquidation.

ENCOURAGING SIGNS SEEN

However, we can now also see encouraging signs of more lasting progress. Attitudes of business and labor toward pricing and wage bargaining and toward work rules that hamper productivity seem to be changing. Not surprisingly, that is most clearly apparent in industries where costs and wages have been most clearly out of line and where international competitive pressures or those resulting from regulatory change are particularly intense.

But so long as monetary and fiscal policies are appropriate, I believe those changes will be reflected in a spreading pattern of cost and price restraint. Individually, workers and businessmen are naturally reluctant to maintain such restraint, partly for fear their concessions will not be matched by those of others. But, collectively, such restraint, combined with higher productivity, will be amply repaid in the form of higher real wages and better prospects for job security. This is the foundation on which we can expect to build a sustainable recovery.

If these brighter prospects are to be achieved, however, we cannot afford, just as the disinflationary process is beginning to take hold, to abandon our monetary vigilance. Past failures to carry through have left a legacy of skepticism and uncertainty among workers and businessmen, among consumers, and, not least, among participants of financial markets, where lenders demand inflation and uncertainty premiums when committing their funds. That is one important factor holding up longer term interest rates.

CREDIBILITY HAS TO BE EARNED

Credibility in dealing with inflation will have to be earned by performance and persistence over time, and I believe it is broadly and rightly recognized that appropriate restraint on the expansion of money and credit will continue to be fundamental to restoring price stability.

Our intentions with respect to money and credit growth in 1982 seem to me consistent with that need. The monetary targets are, we believe, consistent with recovery in real business activity over the second half of the year. In fact, the target range for M_1 is consistent with somewhat larger growth in that aggregate than actual growth of the adjusted measure during 1981.

At the same time, the targets do assume and are, in fact, designed to encourage further progress toward price stability. In that sense, they are a tight fit.

The performance of the credit markets in 1982 and beyond, in a framework of disciplined monetary policy, will be heavily influenced by supply and demand forces other than the course of inflation and inflationary expectations. Key among these is the size of the Federal deficit.

GOVERNMENT AND PRIVATE BORROWING COMPETE

Government borrowing and private borrowing compete for a limited supply of available savings and credit. That competition is usually ameliorated in the midst of a recession because private credit demands are reduced. But a more prosperous economy also implies much stronger needs for mortgage and business credit.

Indeed, sustained recovery of the private economy and the investment we need to support productivity is dependent on more favorable financial market conditions. It is precisely those more favorable market conditions that are threatened by prospects for sharply rising deficits in fiscal 1983 and the years beyond.

Members of this committee are acutely aware that all of the familiar projections by the administration, the Congressional Budget Office and private forecasters point to historically huge deficits, assuming the administration's defense plans are broadly carried out and no new steps are taken to curtail nondefense spending or raise revenues.

We can debate about which estimate is more accurate, but the point is that there is no disagreement that deficits would rise to $150 billion and beyond, in a context of a steadily expanding economy, under any set of assumptions, and deficits of those magnitudes cannot be acceptable, not if we, in fact, want to see the rise in investment and housing we want.

PROJECTING THE FEDERAL BUDGETARY POSITION

Projecting the Federal budgetary position for several years ahead necessarily involves a range of uncertainty about spending and tax programs, the level of interest rates, and overall GNP.

Moreover, there is a range of possible outcomes with respect to our savings potential and sources of funds in the credit markets, even with given assumptions regarding the GNP. Nevertheless, a general implication of the budgetary outlook as it stands is clear enough.

In the absence of action, the projected deficits would be outside the range of peacetime experience for good business years, whether measured in absolute terms or in relation to the potential GNP or in relation to savings.

In recognition of those concerns, the administration has proposed large cuts in spending and some measures to increase revenues. Such action would go a long way toward bringing the deficits down, cutting them by one-half or so in fiscal 1984, according to administration estimates.

But even with such forceful action, the size of the projected deficits would remain large, relative to savings and the GNP, for a relatively prosperous business year. While a few years in the 1970's appear roughly comparable, there would appear to be little or no safety margin for meeting expanded investment requirements. Should the deficit trends be more adverse, as the Congressional Budget Office suggests, the potential for crowding out private investment would be all the greater.

A substantial increase in savings could help protect against the implied squeeze on financial markets. Indeed, business saving is likely to be enhanced substantially by the provisions of last year's tax bill, and personal saving should also be increased as inflation declines and in response to other incentives. But we also need to remember that the larger savings potential should not be dissipated in financing Government purchases or transfer payments when our investment needs are so urgent.

CHOICE CANNOT BE ESCAPED

The hard fact is we cannot escape a choice: whether we want to encourage more favorable financing conditions for the private sector, or whether we are willing to risk seeing our savings from financial resources diverted in large measure to financing a Federal deficit.

While it is the deficits for fiscal 1983, 1984, and beyond that loom so large, action is needed now for several reasons. First, as you know better than I, the budgetary momentum cannot be curbed without planning ahead.

Steps to achieve large reductions in spending or higher receipts in fiscal 1983, only 6 months off, need to be put in place soon, and measures of spending restraint should be undertaken during the current congressional session to be fully effective in fiscal 1984.

Second, deficits of the projected magnitude are, in some degree, self-reinforcing. Prolongation of high deficits and high interest rates feeds back into future debt service and budget expenditures.

PLANNING OF INVESTORS CLOUDED BY UNCERTAINTIES

Finally, and, to me, most important, uncertainties about future credit market pressures cloud the planning of investors today. Strong actions taken now to assure that deficits can and will be reduced as the economy recovers can go far toward galvanizing investor attitudes in a favorable direction.

Paradoxical as it may seem in the light of some past economic analysis—analysis developed when inflation and high interest rates were not a preoccupation—prospects for recovery can be speeded by decisive action by this committee and your congressional colleagues to curb future deficits, for the result would be to relieve apprehension in the market that contributes to today's high rates.

As I noted earlier, if enacted, the proposals by the administration for deficit-reducing measures, totaling over $55 billion in fiscal 1983 and approaching $85 billion in 1984, will go a long way toward ameliorating the potential problem. They represent a major challenge to the Congress, but I would urge upon you the desirability of going even further to reduce demonstrably the pattern of deficits as the economy recovers. The appropriate target, it seems to me, would be to restore the prospect of budgetary balance as a high level of economic activity is restored.

On purely economic grounds, I believe that lower taxes will enable the economy to perform more effectively and that higher marginal tax rates distort incentives and impede economic efficiency.

But you must weigh many considerations, and I recognize the choices before you are extremely difficult and involve detailed consideration of social objectives and program objectives beyond the purview of the Federal Reserve. To the extent the job cannot be accomplished by further steps to reduce spending growth, I see no alternative but action to bring the trend of revenues into better alinement with spending prospects.

ECONOMIC POLICY SEEMS APPROPRIATE

In concluding, I would emphasize that the main directives of economic policy laid out last year seem to me broadly appropriate to the challenge before us. We are making progress against inflation, and sustaining that progress is fundamental to a brighter future. Tax and other policies developed last year should contribute to a more productive, competitive economy.

Some steps have been taken to slow the strong, upward momentum in Government spending. At the same time, the agenda for action is clear. The Federal Reserve will maintain the needed monetary discipline. We need decisive action to curtail budget deficits.

As we approach that agenda, I can only be encouraged by the degree of understanding of the nature and urgency of the problem before us. I believe there is a sense that, difficult as it is, the Congress and the administration have an opportunity in coming weeks to seize the initiative with a strong budget program.

We in the Federal Reserve mean to do our part in fostering confidence in financial markets. Together, we can move from challenge to conviction that the base has been laid for national recovery.

Chairman DOMENICI. Thank you very much, Mr. Chairman.

PREPARED STATEMENT OF PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

I appreciate this opportunity to discuss with you important economic issues that are of concern to all of us. Obviously, interrelationships among monetary, fiscal, and other policies have important bearing on our national economic performance and, especially, on the performance of our credit markets. The Federal Reserve has responsibilities only for monetary policy. This Committee has an important role in shaping the broad outlines of Congressional budget policy and, particularly, in focusing on longer-term budget prospects. This longer-term focus is especially important at the current juncture.

Clearly, the economy is going through troubled times. Unemployment is painfully high, particularly in older industrial regions. Interest rates are imposing severe strains on housing, small business, and agriculture, and on thrifts and certain other financial institutions. These problems are in major part a legacy of high inflation and lagging productivity growth over a number of years. The recession has also played a major role in the current budgetary deficit, which is likely to be more than double the deficit you planned about a year ago.

I believe that there are strong reasons to expect a cyclical upturn later this year. Our monetary policy targets will accommodate such an upturn. And the deficit for the current year, with its large cyclical component, should be manageable; to a considerable extent, by supporting income flows and spending during the recession, it can help stabilize the economy and induce recovery.

For future years, the situation is quite different. We face the bleak prospect, as things now stand, and without strong action to contain spending and to increase revenues, that budgetary deficits will rise very substantially, even assuming satisfactory economic growth. That prospect threatens the recovery in business investment and housing we need by potentially preempting a sizable fraction of our savings potential; moreover, the future implications for congested credit markets feed back on present interest rates, as lenders and borrowers "discount" what might happen in the years ahead. While it might be argued that larger growth in the money supply, now or prospectively, could relieve the pressure, one result would be to renew fears of inflation, just as marked progress toward greater price stability is apparent. An inflationary increase in the money supply cannot substitute for real savings, and, in time, would result in higher rather than lower interest rates.

Clearly, the potential problem before us lies squarely at the intersection of monetary and fiscal policy, and of our respective responsibilities. For that reason, I should like, first, to review the recent and prospective course of monetary policy and then to discuss its relationship to the fiscal problem.

Monetary policy has, of course, been directed toward restraining growth in money and credit with the important objective of reducing inflationary pressures and placing the economy on a course toward price stability. The hard fact is that uprooting a deeply embedded inflationary process is difficult;

it is made even more difficult to the extent the effort is concentrated on one policy instrument. The fact that interest rates have remained painfully high in the midst of recession, restraining activity in credit-dependent sectors of the economy is one reflection of the difficulty. But the problem extends back over a number of years. As you know, the current recession has been superimposed on a pattern of stagnation extending over a considerable period.

In broad terms, I don't think there is any great mystery as to why the economy has behaved this way. Beginning in the mid-1960s, inflation increasingly became a way of life, and in the process distorted economic incentives, sapped our productive energies, and caused arbitrary and capricious transfers of income and wealth. For a time, as inflation gained momentum, real interest rates were low or negative. But after inflation took hold, and became embedded in behavior and expectations, anticipations by borrowers and lenders alike tended to propel interest rates higher. And, as monetary policy moved to deal more forcefully with the inflation -- particularly in a context of fiscal imbalance -- the strain on financial markets became more acute.

The alternative course of simply accommodating inflation by providing it monetary sustenance would, however, offer no lasting relief. By feeding expectations of inflation and reinforcing the reluctance of lenders to commit funds for any but the briefest periods of time, the high level of interest rates (particularly long-term rates) would only become further embedded in the economy. The hard fact is that loss of our most important financial yardstick -- a stable dollar -- bred high and volatile interest rates. Restoration and maintenance of lower interest rates is ultimately dependent on greater confidence that stability can and will be restored.

Developments during 1981 seem to me broadly consistent with that effort. While particular measures of money and credit diverged, responding in large part to legislative, regulatory, and institutional change affecting the way businesses and individuals chose to hold their financial assets, the general direction was consistent with the effort to curb the monetary sources of inflation. Specifically, M1B growth (adjusted for the estimated shift of funds into NOW accounts) decelerated further last year, averaging a little more than 1 percent lower than the previous year -- the third consecutive year of such deceleration. Growth of the broader aggregate M2 averaged a bit higher than in 1980, but that rise, at the margin, reflected extraordinary growth in money market funds and regulatory and legislative changes affecting the attractiveness of time deposits, which pulled into M2 some funds that otherwise would have been placed elsewhere.

Despite the slow growth of the narrowly defined money supply, short-term interest rates fell substantially from mid-year peaks, particularly sharply after the recession took hold. As you know, however, short-term rates retraced part of that decline late in the year and early in 1982. The money supply rose particularly sharply in the early weeks of 1982, and as a result, bank reserve positions came under renewed pressure.

A spurt in money growth is unusual in a context of weak production and income, and it appeared at least partly related to uncertainties on the part of individuals, leading them to shift a portion of their financial assets into the most liquid form. More recently, the excessive growth has appeared to be subsiding, and interest rates have turned somewhat lower. But a characteristic of the past year has been the persistently high level of intermediate- and long-term interest rates, an area of the market most heavily affected by expectations.

Those interest rates have remained high despite visible progress -- and potentially lasting progress -- on the inflation front. To be sure, some of the progress against inflation reflects the more immediate, and potentially reversible, effects of recession-weakened markets, current surpluses in petroleum and grain production, and reduced commodity speculation and pressures generally for inventory liquidation due to extraordinarily high interest rates. However, we can now also see encouraging signs of more lasting progress. Attitudes of business and labor toward pricing and wage bargaining, and toward work rules that hamper productivity, seem to be changing. Not surprisingly, that is most clearly apparent in industries where costs and wages have been most clearly out of line and where international competitive pressures or those resulting from regulatory change are particularly intense. But -- so long as monetary and fiscal policies are appropriate -- I believe these changes will be reflected in a spreading pattern of cost and price restraint. Individually, workers and businessmen are naturally reluctant to maintain such restraint, partly for fear their concessions will not be matched by those of others. But collectively, such restraint, combined with higher productivity, will be amply repaid in the form of higher real wages and better prospects for job security. This is the foundation on which we can expect to build a sustainable recovery.

If these brighter prospects are to be achieved, however, we cannot afford -- just as the disinflationary process is beginning to take hold -- to abandon our monetary vigilance. Past failures to "carry through" have left a legacy of skepticism and uncertainty among workers and businessmen, among consumers, and, not least, among participants in financial markets where lenders demand "inflation" and "uncertainty" premiums when committing their funds. That is one important factor holding up longer-term interest rates. Credibility in dealing with inflation will have to be earned by performance and persistence over time. And, I believe, it is broadly and rightly recognized that appropriate restraint on the expansion of money and credit will continue to be fundamental to restoring price stability.

Our intentions with respect to money and credit growth in 1982, reported to Congress three weeks ago, seem to me consistent with that need. The monetary targets are, we believe, consistent with recovery in real business activity over the second half of the year; in fact, the target range for M1 is consistent with somewhat larger growth in that aggregate than actual growth of the adjusted measure during 1981. At the same time, the targets do assume, and are designed to encourage, further progress toward price stability. In that sense, they are a "tight fit."

The performance of the credit markets in 1982 and beyond, in a framework of disciplined monetary policy, will be heavily influenced by supply and demand forces other than the course of inflation and inflationary expectations. Key among these is the size of the federal deficit.

Government borrowing and private borrowing compete for a limited supply of available savings and credit. That competition is usually ameliorated in the midst of recession because private credit demands are reduced. But a more prosperous economy also implies much stronger needs for mortgage and business credit; indeed, sustained recovery of the private economy, and the investment we need to support productivity, is dependent on more favorable financial market conditions. It is precisely those more favorable market conditions that are threatened by prospects for sharply rising deficits in fiscal 1983 and the years beyond. Members of this Committee are acutely aware that all of the familiar projections, by the Administration, the Congressional Budget Office and private forecasters, point to historically huge deficits, assuming the Administration's defense plans are broadly carried out and no new steps are taken to curtail nondefense spending or raise revenues. We can debate whether the estimates of the Administration or the Congressional Budget Office are more accurate. But the point is that there is no disagreement that deficits would rise to $150 billion and beyond, in a context of a steadily expanding economy, under either set of assumptions, and deficits of those magnitudes cannot be acceptable -- not if we, in fact, want to see the rise in investment and housing we want.

Projecting the federal budgetary position for several years ahead necessarily involves a range of uncertainty about spending and tax programs, the level of interest rates, and overall GNP. Moreover, there is a range of possible outcomes with respect to our savings potential and sources of funds in the credit markets, even with given assumptions regarding the GNP. Nevertheless, some general implications of the budgetary outlook as it stands are clear enough.

In the absence of action, the projected deficits would be outside the range of peacetime experience for good business years, whether measured in absolute terms or in relation to the potential GNP and savings.

In recognition of those concerns, the Administration has proposed large cuts in spending and some measures to increase revenues. Such action would go a long way toward bringing the deficits down, cutting them by one-half or so in fiscal 1984 according to Administration estimates. But even with such forceful action, the size of the projected deficits would remain large, relative to savings and the GNP, for a relatively prosperous business year. While a few years in the 1970s appear roughly comparable, there would appear to be little or no "safety margin" for meeting expanded investment requirements. Should the deficit trends be more adverse, as the Congressional Budget Office suggests, the potential for "crowding out" private investment would be greater.

A substantial increase in savings could help protect against the implied squeeze on financial markets. Indeed, business saving is likely to be enhanced substantially by the provisions of last year's tax bill and personal saving should also be increased as inflation declines and in response to other incentives. But we also need to remember that the larger savings potential should not be dissipated in financing government purchases or transfer payments when our investment needs are so urgent.

The hard fact is we cannot escape a choice -- whether we want to encourage more favorable financing conditions for the private sector or whether we are willing to risk seeing our savings and financial resources diverted in large measure to financing a federal deficit.

While it is the deficits for fiscal 1983, 1984, and beyond that loom so large, action is needed now for several reasons. First, as you know, the budgetary momentum cannot be curbed without planning ahead. Steps to achieve large reductions in spending or higher receipts in fiscal 1983 -- only six months off -- need to be put in place soon, and measures of spending restraint should be undertaken during the current Congressional session to be fully effective in fiscal 1984.

Second, deficits of the projected magnitude are in some degree self-reinforcing. Prolongation of high deficits and high interest rates feeds back into future debt service and budget expenditures.

Finally, and most important, uncertainties about future credit market pressures cloud the planning of investors today. Strong actions taken now to assure that deficits can and will be reduced as the economy recovers can go far toward galvanizing investor attitudes in a favorable direction. Paradoxical as it may seem in the light of some past economic analysis -- analysis developed when inflation and high interest rates were not a preoccupation -- prospects for recovery can be speeded by decisive action by this Committee and your Congressional colleagues to curb future deficits, for the result would be to relieve apprehension in the market that contributes to today's high rates.

As I noted earlier, if enacted, the proposals by the Administration for deficit-reducing measures totaling over $55 billion in fiscal 1983 and approaching $85 billion in 1984 would go a long way toward ameliorating the potential problem. They represent a major challenge to the Congress, but I would urge upon you the desirability of going even further to reduce demonstrably the pattern of deficits as the economy recovers. The appropriate target, it seems to me, would be to restore the prospect of budgetary balance as a high level of economic activity is restored.

On purely economic grounds, I believe that lower taxes will enable the economy to perform more effectively and that higher marginal tax rates distort incentives and impede economic efficiency. But you must weigh many considerations, and I recognize the choices before you are extremely difficult and involve detailed considerations of social objectives and program objectives beyond the purview of the Federal Reserve. To the extent that the job cannot be accomplished by further steps to reduce spending growth, I see no alternative but action to bring the trend of revenues into better alignment with spending prospects.

In concluding, I would emphasize that the main directives of economic policy laid out last year seem to me broadly appropriate to the challenge before us. We are making progress against inflation, and sustaining that progress is fundamental to a brighter future. Tax and other policies developed last year should contribute to a more productive, competitive economy. Some steps have been taken to slow the strong upward momentum in Government spending.

At the same time, the agenda for action is clear. The Federal Reserve will maintain the needed degree of monetary discipline. We need decisive action to curtail budget deficits.

As we approach that agenda, I can only be encouraged by the degree of understanding of the nature and the urgency of the problems before us. I believe there is a sense that, difficult as it is, the Congress and the Administration have an opportunity in coming weeks to seize the initiative with a strong budgetary program. We in the Federal Reserve mean to do our part in fostering confidence in financial markets. Together, we can move from challenge to conviction that the base has been laid for national recovery.

Chairman **Domenici**. I have just a couple of questions and then I will yield to the Senators here.

Chairman Volcker, why are interest rates so high in the midst of a recession that is almost 9 months old?

I would give you my notion and ask if you would agree. Would you agree that the large deficits that we are now projecting lead people to believe that either real interest rates are going to be very high or that the Fed will ultimately have to monetize and inflation premiums will be higher again in the future?

Mr. **Volcker**. Yes, I think that is one factor. I do not think that is the only factor, but that is an important factor that looms in the market thinking today and has for a year or more.

STILL GOOD DEAL OF SKEPTICISM

Chairman **Domenici**. Mr. Volcker, with the recession now about 9 months old, is that the principal reason that interest rates have not come down?

I mean, obviously, you have not loosened money, so we do not have the second part of my assumption of an expectation of high inflation again which would come with monetizing the large debt. Since you have not done that, why are they still so high?

Mr. **Volcker**. Despite the fact that we have not done that, I think there still is a good deal of skepticism. Part of it is related to the budgetary picture that you described accurately. It is impossible to distinguish the different factors, but, for one, we have come off of 15 years of inflation. I think we are in the process of turning that around.

Even apart from the budgetary problem, people have been disappointed in the success of an investment strategy of buying bonds for years; there have been losses in bonds. Inflation has tended to mount over those years; there was some temporary improvement during recession periods, but then inflation went back to higher levels than it was before.

After people have seen that pattern for 15 years, they get a little cynical, at least skeptical, about whether, in fact, it is going to be turned. I think there is increasing evidence that we are turning, but we have not got victory in the bag yet. We are going to have to persist with our policies—and the budgetary picture again comes in—to be totally convincing that inflation is coming down.

Again, that is related to the deficit picture, but it is not entirely a question of deficits. We also have that historical experience which people look back at.

I think it is also fair to say that monetary policy—restraining the money supply, all other things being equal—tends to have short-term rates higher than they would otherwise be in the short run. But, in the long run, I think monetary policy is a favorable factor.

Normally, in a recession you can have restraint on the money supply and interest rates go way down. You correctly raised the question of why that did not happen to the same degree, or at least to the same level, to interest rates as in past recessions.

EMPHASIS PLACED ON CREDIBILITY

Chairman DOMENICI. Yesterday, three economists testified, and I think they come from various spectrums within the economic discipline. They all agreed, Mr. Volcker, that if Congress was able to produce a credible budget that predicted significantly lower deficits than those that the President's budget has predicted, and they were credible. Furthermore, they assumed interest rates would begin to come down and that it would occur rather quickly if it was credible; and they would come down rather rapidly, based upon their knowledge of the other ingredients of this economic pie in America.

What are your thoughts on that?

Mr. VOLCKER. I would agree with that, and I would agree with the emphasis that you put on the word "credible." Given all the skepticism that I mentioned, you have a critical audience out there, and anybody can guess how they would react to a resolution or a statement of intentions.

I think the more that this can be built into law, the more you will be convincing and see a market reaction. I do not think you can help but see it because the budget deficit is a major preoccupation of the markets at present.

Chairman DOMENICI. Well, Chairman Volcker, you are in a most important position. If what we hear from our constitutents and if what we heard yesterday from the economists that I described—interest rates are now assumed by most of us to be the most significant negative situation in this American economy, to the extent that it is being said that if they do not come down soon and stay down for a reasonable period of time, there will not be any recovery; to the contrary, we will have further economic decay bordering on disaster.

INTEREST RATES MAJOR PROBLEM FOR ECONOMY

Do you now agree that the high interest rates are indeed causing significant—not just minor, but significant economic problems in America today, and not just sporadic and here and there, but as a general thing?

Mr. VOLCKER. I do not think there is any question that the level of interest rates is a major problem for the economy. I was about to say it is the single hazard; there may be others, but certainly it is the most important single hazard in terms of the short-run business outlook.

I do think that the great probability is that we are going to see a leveling off of the economy and some recovery soon, but the question mark in that outlook does revolve around interest rates.

I would want to emphasize this: it is not just a question of whether you are going to have some recovery—I think you are going to have some recovery—but of the sustainability of that recovery—whether it lasts or whether it turns out to be a rather temporary affair and we slip back into the morass again—and that has a lot to do with the budgetary position.

Chairman DOMENICI. One last question. You have properly indicated that as far as out-years—1984, 1985 and 1986—we have various projections. We have to do our best on this committee to make some assumptions; the President has made his.

But I would just ask you this question. If the Congress does not give the President his cuts and we do nothing, it is generally assumed that the deficit for 1983 will exceed $155 billion. I do not think anybody will have to speculate much on that; that is a given. In fact, I think that is the lower range of the assumptions.

Mr. VOLCKER. And even assuming recovery during that period.

Chairman DOMENICI. And assuming recovery, precisely.

SUSTAINED RECOVERY QUESTIONABLE

Now, Mr. Volcker, could you tell us whether you would assume that this economy can sustain that kind of deficit and have interest come down and a real recovery occur?

Mr. VOLCKER. No. I would think it is very doubtful under those circumstances that you would see favorable financial market conditions, which raises the questions of whether a recovery could be sustained.

If you are talking about $155 billion during a period of recovery, you may be making assumptions contrary to facts: The recovery probably would not be developed, or at least be sustained, under those conditions, because so much of the potential savings of the economy would be absorbed by the Federal deficit. There is not going to be much left over for the increase in housing and business investment you would like to see.

Chairman DOMENICI. Senator Hollings?

Senator HOLLINGS. Continuing on this same line, let me ask this question, Mr. Chairman. If we can all agree on what the problem is, then we might find the right direction. We get suggestions that we ought to move up the tax cuts and suggestions to defer them. We find different Members going in different directions.

LARGE DEFICITS ARE BUDGET PROBLEM

I was impressed yesterday by the fact that you could get Ken Galbraith and Allan Greenspan and Otto Eckstein to agree that the budget problem facing the U.S. Congress was not recession-related, but a long-term problem from the large deficits. Do you agree with that?

Mr. VOLCKER. Yes. I think all the witnesses that I have heard before you or before other committees have made that point. What is unique about this situation is that you have rising deficits even assuming business recovery and expansion for a number of years ahead.

I do not know of any time in the past when you could assume a growth in the economy of 4 or 5 percent a year and project widening deficits. The typical pattern in that situation is that you get narrowing deficits and surpluses.

Senator HOLLINGS. I gain heart because you are being realistic when you say, "I urge upon you the desirability of even going further to reduce demonstrably the pattern of deficits," which I think would be necessary when we talk about credible action to be taken this year.

If you have got around a $150 billion deficit facing you and you have got a package of $50 billion in tax expenditures, revenues or spending cuts, you are still left with $100 billion deficit. You program that out into 1985. The President still comes up with a $70-some billion deficit in excess of this year.

Analyzed by the Congressional Budget Office, they characterized that same deficit as $140—just about double. Is that credible enough to start interest rates down this year?

Mr. VOLCKER. You are obviously better off than if you did nothing.

Senator HOLLINGS. Right. Now, what would the Federal Reserve do? We are talking to the man now, and should not interest rates start down? Is that credible or not?

FEDERAL RESERVE TO FOLLOW PATTERN LAID OUT

Mr. VOLCKER. I think you would assume that the Federal Reserve is going to follow the pattern that it has laid out in terms of the growth in money and credit. For 1982, we have set out a range of numbers. We have said that we would find it acceptable, based upon what we know now, if we were to be in the upper part of that range. I would feel a little more comfortable about that if you took strong budgetary action.

The point that I would emphasize is that consistent with any given growth in the money supply, and certainly consistent with what we are projecting for our own operations, the more you do on the budget, the lower interest rates will be.

Senator HOLLINGS. The more we do with the budget, the lower the interest rates will be. Then let us put it this way: if we had a plan somewhat similar to the one I have proposed of, in essence, reenacting the 1982 budget, which the President found a wonderful budget when he signed it in December—some of his colleagues now find it ridiculous and simplistic in February and March.

But in any event, if you had the current policy for health which I have projected, and various other things, but a freeze on increases—not cutting anything, but a freeze on the increases there, and you saved $100 billion, then that should bring the interest rates down even more, should it not?

Mr. VOLCKER. Yes. I think, just looking at interest rates, that would bring them down even more. You have proposed a very strong program. Obviously, it raises questions on other fronts but you asked me only about interest rates.

Senator HOLLINGS. Right.

Mr. VOLCKER. That strong a program is going to bring them down even more.

Senator HOLLINGS. Thank you very much.

Chairman DOMENICI. Senator Gorton?

Senator GORTON. Chairman Volcker, you have come up with a clear, cogent, and I think convincing analysis of the economy and of where we are going. But I would simply like to ask for a few of your own insights as to the details of the direction in which we are going and ought to go.

LARGER DEFICITS ANTICIPATED

Yesterday, Dr. Greenspan indicated his belief that current interest rates were discounting considerably more than the nominal deficits proposed in the President's budget; that is to say that they were really based on the proposition that the deficit would be more in the $120 to $140 billion range than the 90-plus which the President had indicated. Do you agree with that analysis?

Mr. VOLCKER. Of course, nobody knows the answer to that question for sure. You cannot get into the minds of the markets that accurately. But I would suspect that is true. I certainly think you would find people in the market anticipating that the deficit will be larger than that proposed in the President's budget. If that is translated into behavior, as I assume it is, I think Mr. Greenspan is probably right.

Senator GORTON. You went on to answer Senator Hollings just a moment ago that a spending proposal such as his would have, whatever its other effects, a positive impact on lowering those interest rates.

Mr. VOLCKER. Yes.

Senator GORTON. And do I take it that you would go beyond that to say that every bit as important in that formula is the trend of the deficit down to zero or close to zero by 1985?

Mr. VOLCKER. Yes, I do believe that because I think the arithmetic of this problem is very clear. You are facing a problem of diverging spending and revenue lines, and people are expecting a deficit. The economy can operate with a deficit when you have got excess capacity and unemployment; it is a matter of degree.

But, as you get out to 1984–85, and you project a very good economy in those years and you still see a very large deficit, you have got a tremendous problem, because that is when the squeeze would really be apparent. So, I think a focus on 1984–1985 and what forces are in motion that will affect those deficits is very important.

ECONOMY IMPACTED SOMEWHAT DIFFERENTLY

Senator GORTON. Now, you have also included in your formal statement opinion about the way in which one reaches that balance. I take it that you believe that the economy will be impacted somewhat differently at least by a path to a balanced budget which relies heavily on increased revenues against a path to a balanced budget which relies more heavily on at least a decreased rate in the growth of expenditures. Am I correct in that?

Mr. VOLCKER. Yes.

Senator GORTON. Would you expand on that a little?

Mr. VOLCKER. Yes. I am talking, obviously, in the abstract now, and I would make the general point that I think the private economy will be more vigorous, you will have more room for incentives, you will have a better climate for investment, if you are operating the Government at a lower percentage relative to the rest of the economy than otherwise, with lower spending and with lower taxes.

That has to be fit into the real world, where you have defense needs, you have social needs, and all the rest. I would simply say, do all you can, to keep spending as low as you feasibly can in light of all your objectives, but then do not shrink from closing the gap on the revenue side if something is left to be done, as seems likely.

DIFFERENCE IN REVENUE-RAISING MEASURES

Senator GORTON. I think that assumption is entirely correct. Within the frame of reference of increased revenues, is there also an impact on productivity and on growth in the economy? Is there a difference, for example, in making up what remains of the deficit by terminating entirely or postponing individual income tax cuts, as opposed to making it up in the way of excise taxes, some changes in tax preferences, and some changes in the corporate tax code? Could you comment on that?

Mr. VOLCKER. Yes, I believe there is a difference. Again, Senator Gorton, I think last year's tax bill which, obviously, is controversial and raised questions as to the size of cut was straightforward and valid in its rationale of reducing marginal tax rates and enhancing corporate savings. I think there is a question, over a longer period of time, as to whether this country has not relied too much on direct taxation, with very high tax rates at the margin, than is good for the health of the economy.

In that sense, yes, I would encourage you to look at revenue-raising measures either in the excise tax area—in the energy area, in particular, where there may be other economic objectives to be sought from particular tax programs—or in closing loopholes. I think there is much to be said for that in terms of economic analysis.

Senator GORTON. Mr. Chairman, I thought those lights had burned out.

Chairman DOMENICI. No; they are right on.

Senator GORTON. Thank you, Chairman Volcker.

Chairman DOMENICI. I do not think we have violated the rules today.

Senator Riegle?

Senator RIEGLE. Thank you, Mr. Chairman.

ECONOMY DAMAGED BY HIGH INTEREST RATES

Mr. Volcker, it seems to me that what we are seeing and hearing from other economic experts is that the high interest rates are doing tremendous damage to the economy. These rates are causing massive hardship to people across the country, particularly in terms of growing unemployment.

We are losing 500 businesses a week to bankruptcy, and that number is accelerating. We have got at least 10 million people out of work in the country and that number seems to be accellerating. We have dropped down to 70 percent of plant utilization, on the average, across the country. We have a major part of our asset base sitting idle and unproductive.

The leading indicators, which we received yesterday, are still negative. It is a very sad and distressing picture and it does not appear from any evidence that this situation is getting better.

The President has sent us what is clearly an unrealistic budget. In fact, it is so unrealistic—and you have, in a sense, confirmed that somewhat delicately in your testimony—it has been rejected by 100 Senators in both parties as being unworkable—the first time that has ever happened.

Clearly, the Reagan deficits have to be reduced. As recently as yesterday, the President, apparently, in meeting with Republican leaders from the Congress who have tried to persuade him that that is the case, continues to be very stubborn and very unrealistic about it.

BIPARTISAN PLAN NEEDED

I think what we need here is an urgent, bipartisan plan where both parties work with the White House and with the Fed. We need to craft a change in the fiscal and monetary mix which will give us a situation where the out-year deficit can come down, where we have confidence that they will be coming down, and where we can get an immediate response in terms of lower interest rates.

The problem is that while many in Congress believe that, the administration does not. The President most of all seems to be the one who does not believe that that is necessary. We are stymied at the moment. We are caught in a kind of paralysis in which we are unable to craft that kind of bipartisan arrangement and make changes in the economic plan in which all three parties—the executive branch, the Congress and the Fed—could work on a cooperative basis to move us to a sounder track and to start bringing interest rates down and getting people back to work.

With that as the situation, I want to make a suggestion to you, if I may, because you have a part to play in any arrangement of that kind. But you also have another important part to play apart from any arrangement that we may be unable to put together at the moment. I believe we have now reached the point in terms of the damage that I see occurring—and much of it permanent damage to the economy—where I think the Fed has to seriously consider taking unilateral action which could bring down the interest rates for the next 3 months. I am talking about the short-term problem. I am not talking about solving the long-term problem, because right now we have got an immediate, urgent, short-term problem to which we are not paying sufficient attention.

DO SOMETHING ABOUT INTEREST RATE RELIEF

We have a major problem when plant capacity is down to 70 percent, and falling, and you have at least 10 million people out of work. In light of the stubbornness and unwillingness of the President to adjust the budget at this time, I think it is both possible and wise for you to think about doing something that can give us some interest rate relief in the short term so that we do not keep losing 500, 600, 700 businesses a week. These are businesses which will not come back quickly when the rates finally do turn around.

Once you dismantle these businesses and force them into bankruptcy, it is not as if we can wave a wand and suddenly have them back in operation a month or two or three later. I think the time has come where stubbornness in one quarter ought not to just be matched by equivalent stubbornness in another quarter.

I think in the Congress, we have an affirmative obligation in both parties to work cooperatively to change this economic mix. But until that is hammered into place and until we have some positive response from the White House, I think the Fed has an obligation in its own right to face up to the damage caused by the high interest rate policy.

You can do something about short rates; you can do something about the prime rate. I am suggesting that it is time for you to consider doing that, and I would just add this thought to it.

Let us say you did that the next 2 or 3 months, with the idea of giving the economy a little of oxygen and a little more money to work with so as to stave off some of these bankruptcies. It is hard for me to believe that that would set off a huge inflationary spiral when we have such a low plant utilization.

If, in that period of time, the White House does not come to its senses and we cannot work out some accommodation that brings these deficits under control, you felt there was still a need for tight money and the high interest rates that we are seeing now, you could return to that policy in 40, or 50 days or 60 days.

It seems to me that you would not foreclose your options, but you would provide in the interim some chance for not only businesses but individuals to survive this crunch that is snuffing them out.

LOSSES EXCEED GAINS IN TIGHT MONEY POLICY

At some point, the cost of this tight money policy, the losses generated by it, exceeds the gains produced by it. I think we have crossed that line. I am not trying to say that you ought to bear the burden alone; I do not think you should. I think it ought to be a collective burden.

But when the administration is unwilling to be part of a three-party agreement of that kind, we cannot get very far. That is the situation we find ourselves in right now. You have met with the President within the last 2 weeks. I do not know if you found a willingness that we have been unable to detect that the President is ready to sit down on an urgent basis and work out a major mid-course correction. Such a connection could allow us to receive out-year fiscal restraint in exchange for near-term monetary relief and lower interest rates.

If you have any sign of that, I think we ought to hear about it so we can follow up. I have not detected any sign in any other place.

Mr. VOLCKER. Let me make a couple of comments in response to your statement, Senator Riegle. You used a number of words to characterize either the administration's attitude or the President's attitude; they will speak for themselves. But I do not think the Federal Reserve is being stubborn in this area. I think we do have a very difficult problem. I would be delighted to see interest rates decline, obviously. But you attribute——

Senator RIEGLE. You do have something to do with that. I mean, in all honesty, it is not as if you are a helpless bystander.

Mr. VOLCKER. It is perhaps not quite as simple as you imply, Senator.

Senator RIEGLE. I am not saying that it is simple.

Mr. **Volcker**. The real problem is that we could take action that theoretically, on the basis of traditional economic analysis, you would expect to produce lower interest rates. The question is whether that action would be lasting and how effective it would be in the short run when we still have a set of attitudes out there and a psychology that is extremely sensitive to what the inflationary implications are of our actions.

In discussion with the chairman earlier, I noted the sensitivity about that with respect to the budget, but not only with respect to the budget. Of course, our operations come under very close scrutiny in the market, and if those actions were interpreted as being inflationary, I think we would not get the result that you are talking about. Even if we got it for your 40 days, which would be a rather long period of time, we might get that at the expense of actually aggravating the problem in the 40 days following.

Senator **Riegle**. Well, that is one way to argue it. What I am saying is that we must break this logjam and work out some kind of a major change in the fiscal policy. The clock is running and weeks are going to pass before that happens.

PAY MORE ATTENTION TO SHORT-RUN PROBLEM

First of all, the President has said he is not prepared to do that now. That, by itself, delays the process. What concerns me is that I do not see you paying any attention to the short-run problem.

I support paying attention to the long-run problem, but you cannot do that to the complete exclusion of paying attention to the short-run damage. Why is it not possible to treat both parts of the problem? Why can we not find a way now to treat both parts?

Mr. **Volcker**. We try to. We analyzed the short-term problem just as hard as we could; and we analyzed both the short and long run just a few weeks ago, when we set our targets for this year.

As I indicated, we would anticipate at present a somewhat larger growth, at least in the narrow money aggregates, than we had last year. Perhaps the right word for that growth is "ample"—"generous" is not the right word—in terms of a supply of money that is consistent with economic recovery.

At least in major part, you have to look elsewhere for the factors that are blocking our financial markets at the moment, because historical experience alone would suggest, in the midst of recession, that the kind of monetary growth we have had should be accompanied by lower interest rates.

Indeed, in the past week or two, interest rates have come down, but let me point out that we had a burst in the money supply in January, in particular, which created a certain amount of concern in the market, and interest rates went up.

ADJUSTMENTS NEED TO BE HAMMERED OUT

Senator **Riegle**. Well, prime is stuck at 16.5, and most small businesses are borrowing at two or three points above prime, if they can obtain the money. I am telling you that such a high rate is snuffing out an increasing number of businesses. I do not see how that serves the country's interests.

Mr. **Volcker**. I have no quarrel with——

Senator **RIEGLE**. What we need to do, and what we seem unable to do, is to bring you and the President, or his economic advisers acting in his behalf, together with the leaders of both parties in the Congress. We need to sit down in the same room, around the same table, on a nonstop basis. We ought to treat this as the No. 1 national priority that it is, and hammer out the necessary adjustments.

The fact of the matter is we are not doing that. We are not even close to doing that. And while there is an increasing consensus that that needs to be done, the President is of a different view at the moment. Thus the meeting cannot take place. He, in fact, must convene that meeting. It is very difficult for you to convene it; it is very difficult for the Members of the Congress to convene it.

But time is running. By the time we awaken in another 2, 3, 4, or 5 months, we may have lost this opportunity.

Mr. **VOLCKER**. I fully share your view that the time to act is now, in the coming weeks.

Chairman **DOMENICI**. Senator Riegle, your time is expired.

Senator Boschwitz?

Senator **BOSCHWITZ**. Let me comment, Mr. Chairman, for just a moment about Senator Riegle's comment that the Reagan budget has been rejected by 100 Senators. Let me correct that by at least one Senator by saying that I have not rejected the President's budget.

I am not in complete accord with the President's budget. I have made some of my own proposals, but I found that when President Carter, who was the only other President under whom I have served, presented a budget, one could make the same statement because we always disagree with some aspects of it.

Senator **RIEGLE**. I would just say to the Senator, if he would yield, that I would amend my statement to say that I have not found a single Senator that supports the President's budget.

Senator **BOSCHWITZ**. I support the President's budget as it serves as a catalyst to get on with the business of this Nation in balancing the budget. He put us on the path last year, and the fact that I do not support every aspect of the path that he has chosen to continue this year is not an indication that I reject his budget at all.

LOCKING INTO A BALANCED BUDGET WOULD BE FAVORABLE

Mr. Chairman, I agree with Senator Riegle and the others who have spoken that interest rates are probably the toughest element of the economic scene at the moment. Let me rephrase a question our chairman has asked you. If this committee and Congress adopts a path toward a balanced budget and locks it in with a reconciliation resolution that demands changes in authorizations on entitlement and appropriated programs, what would be the impact on interest rates within the foreseeable future?

Mr. **VOLCKER**. If that is locked in, it would be bound to have a very favorable effect on interest rates. The market is going to be looking at what the Congress does and what the President does, and all the rest.

The key is on the locking it in, I think, and doing what is convincing and what is credible.

Senator BOSCHWITZ. Well, I hope that we do step in that direction, and I believe that many of us will try to make it as credible as possible. I think the tool this committee should use is the reconciliation resolution.

If we were to create that path toward a balanced budget and lock it in as best we could, what would be the effect on interest rates within a 30-, 60-, 90-, or 120-day period?

Mr. VOLCKER. I hate to make a quantitative estimate. Interest rates are 1 percent lower now than they were a week ago; so you get a range of fluctuation in the best of circumstances. But I think such action would have very noticeable effects. You say "locked into a balanced budget." I do not know what time frame you have in mind or what deficit figure you have in mind.

Senator BOSCHWITZ. Probably a 3- or 4-year period.

Mr. VOLCKER. It is going to take at least 3 or 4 years to get down to that level. If you were credibly on that path, I would think it would make a several-percent difference.

TOO EARLY TO TELL IF IRA IS SUCCESSFUL

Senator BOSCHWITZ. Mr. Chairman, you spoke about the importance of savings. Have you any figures on how much has been put into IRA accounts or how successful that program has been?

Mr. VOLCKER. I saw some figures yesterday, which I do not recall, and which are very early returns. The response is very mixed in individual institutions. It is not an avalanche at this point. The important thing, in the end, is some analysis, which does not just jump out of the figures, of how much of that is new savings as compared to how much is a reallocation of existing funds.

I think it is too early to have a meaningful answer to that.

Senator BOSCHWITZ. Yesterday, Dr. Greenspan commented about the decline in demand for hard goods. I wonder whether or not these savings, which would initially have an impact on such a decline——

Mr. VOLCKER. It is conceivable, but I think the general experience has been that people do not leap at the first opportunity. These IRA's became available in January; people have got a long time to be able to make the investment and take the tax credit.

I do not think you would find anything terribly dramatic at the moment, although the experience in some particular institutions has been very favorable in terms of getting a lot of money.

Senator BOSCHWITZ. In conclusion, Mr. Chairman, I agree with you that I would want to impact the revenue last and impact the spending side of the budget first, though I think some of us would indeed not object to impacting the revenue side if we saw some real, meaningful, credible budgetary action leading to cuts in the outyears. We would then impact the revenue side as well.

Thank you, Mr. Chairman.

Chairman DOMENICI. Senator Sasser?

Senator SASSER. Thank you, Mr. Chairman.

Mr. Volcker, I want to follow on here on some questions and statements that Senator Riegle made. I think the economic statistics coming out of this current recession truly are staggering. Let us face it; in certain areas of this country it is not a recession, it is a depression.

There are areas of this country that have unemployment in excess of 15 percent. I come from a Sun Belt State, and our latest unemployment figures from the Sun Belt State that I represent, Tennessee, is over 12-percent unemployment, and we are starting to see that pop up now all over the Sun Belt.

We have got 30-percent industrial capacity idle across this country. Automobile production is slightly over half of what it averaged during the decade of the 1970's, and housing sales of single-family homes last year were 25 percent, really, of what they need to be to meet the housing needs of this country.

Over 10 million people are unemployed, and millions and millions more are underemployed. Now, these are the signs, I think, obviously, of a very sick economy. I think that interest rates are the primary culprit behind the serious economic difficulties that this country is experiencing.

CAN FEDERAL RESERVE LOWER INTEREST RATES IF CONGRESS CUTS BUDGET

The question that I want to put to you is it looks like it is going to be up to us here in the Congress to fashion a budget that this country can live with. But if we in the Congress came up with substantial budget cuts in 1983 and beyond that would cut $30 to $50 billion a year off the Federal budget, is the Federal Reserve Board, under your leadership, prepared to take steps to reduce interest rates to more realistic levels?

Let us just pull a figure out of the air of a 10- to 1-percent range. If we would carry our burden here and bite the bullet and reduce this budget deficit, can we get a commitment out of you that you would work and move to get these interest rates down to a range where people can once again do business?

Mr. VOLCKER. Again, I think the question implies more power on our part than we, in fact, have. Let me just make one comment about your general statement. You said interest rates were the primary culprit.

Senator SASSER. I said, in my judgment, they are.

Mr. VOLCKER. I understand. In some immediate sense, obviously interest rates are a very important factor in this situation, but I think you have to go back and ask yourself why interest rates are so high and what kinds of problems we have inherited.

We got into this situation not, in my judgment, in 1981; we got into this situation as a culmination of a whole set of developments over the previous decade and more. We are making some progress, in my judgment, in dealing with those problems.

Senator SASSER. Well, let me just ask you this, Mr. Chairman. I do not mean to interrupt you, but I am getting a little weary of this business of pointing the finger back at what happened 20 or 30 years ago.

We have the highest interest rates, in real terms—that is, corrected for inflation—in this century, or among the highest. Last quarter, we had a 7-percent rate of inflation, and right now we have got a 16.5-percent prime rate. Senator Riegle says small business pays 2 percent over, and they do.

So, what we are operating with, effectively, is an 8.5- or 9-percent real interest rate. Now, traditionally, we have operated with a 2- or 3-percent real interest rate. We have operated with that, if I remember my figures correctly, since the Second World War, except for some years when there was a negative and some years when they were higher.

Now, why are we having to move now with these interest rates that, corrected for inflation, are that high?

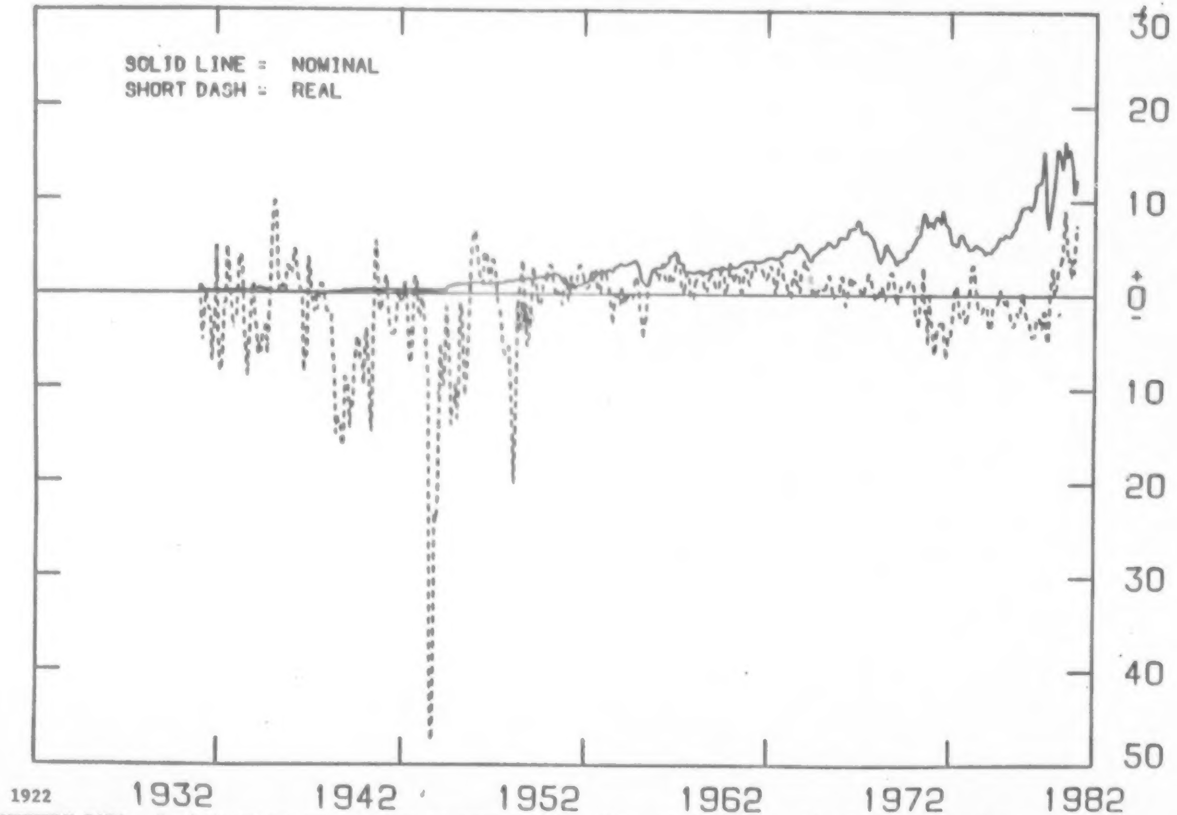
INTEREST RATES ARE HIGH BECAUSE OF PAST EXPERIENCES

Mr. VOLCKER. One of the difficulties is that a real interest rate, which is presumably a measure taken in comparison against what people expect inflation to be, cannot be measured. If you look at interest rates against last month's consumer price index, you have got an extraordinarily high level of real interest rates.

But what is in people's minds is a fear of what might happen, not what last month's consumer price index was. You can try to approximate that by plotting real interest rates. I have a couple of charts here you may be interested in. One plots today's interest rates against the last 3 years' inflation, on the assumption that people roughly think inflation in the next coming years may be the same as the last 3 years. If you look at that kind of chart, real interest rates look relatively high, historically, but not extraordinary; they are not higher than they were during much of the late 1960's, for instance.

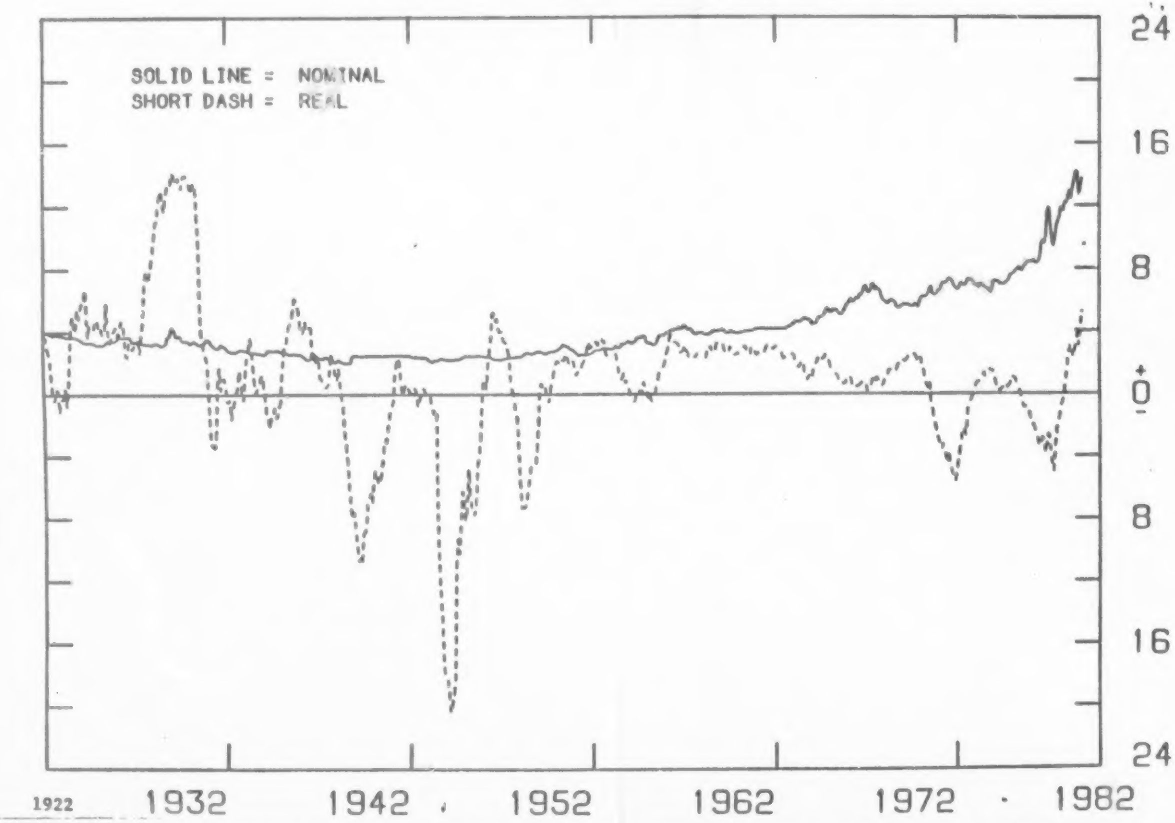
[The following charts depict the behavior of "real" interest rates over the past 50 to 60 years. The measure of inflation expectations, which must be deducted from the observed nominal interest rate, is based on the actual behavior of consumer prices in the recent past. It will be observed that, although the present level of real rates is relatively high, that level has been equaled or exceeded in prior periods. Moreover, the recent bout of high real rates has been a brief one, thus far. In addition, for many borrowers, the effective after-tax cost of credit is not as high on a comparative basis as it has been at many times in the past when tax rates were lower.]

NOMINAL AND REAL INTEREST RATES
THREE MONTH TREASURY BILLS



MONTHLY DATA. Real interest rate series is computed by subtracting the annualized percentage increase in the Consumer Price Index during the preceding three months from the nominal coupon-equivalent Treasury bill rate.

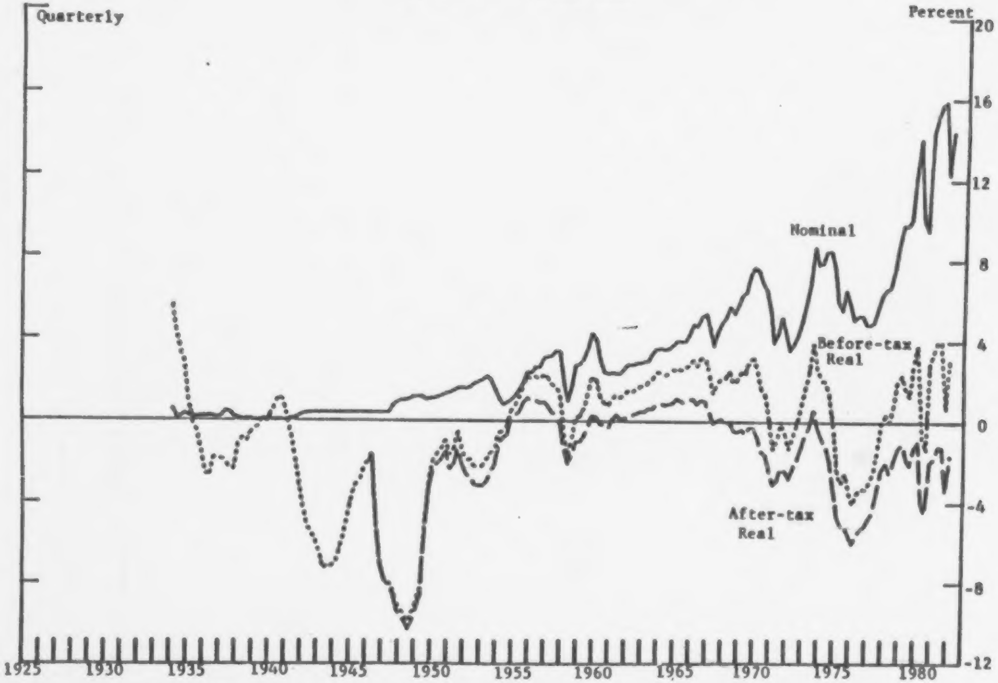
NOMINAL AND REAL INTEREST RATES
LONG TERM TREASURY BONDS



MONTHLY DATA. Real interest rate series is computed by subtracting the percentage increase in the Consumer Price Index during the preceding twelve months from the nominal long-term Treasury bond interest rate.

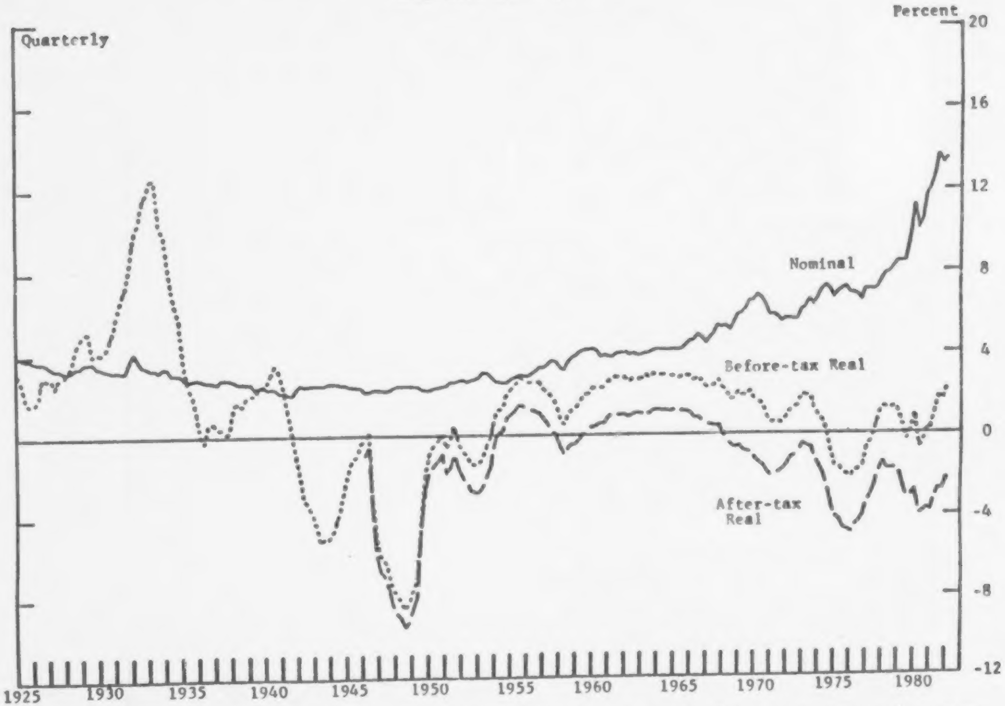
NOMINAL, BEFORE-TAX REAL, AND AFTER TAX REAL INTEREST RATES[1]

Three-Month Treasury Bill



1. The before-tax real interest rate is the difference between the nominal interest rate on three-month Treasury bills (measured on a coupon equivalent basis) and the expected rate of inflation, where the latter is computed as a 12-quarter moving average of actual inflation rates (using the Consumer Price Index). The after-tax real interest rate is computed by subtracting the expected rate of inflation from the after-tax nominal interest rate, where the latter is given by the product of the nominal interest rate and 1 minus the tax rate. The tax rate used here is the effective corporate income tax rate on a NIPA basis.
2. Latest data plotted is February 18, 1982.

NOMINAL, BEFORE-TAX REAL, AND AFTER TAX REAL INTEREST RATES[1]
Long-Term Treasury Bond



1. The before-tax real interest rate is the difference between the nominal interest rate on long-term Treasury bond and the expected rate of inflation, where the latter is computed as a 12-quarter moving average of actual inflation rates (using the Consumer Price Index). The after-tax real interest rate is computed by subtracting the expected rate of inflation from the after-tax nominal interest rate, where the latter is given by the product of the nominal interest rate and 1 minus the tax rate. The tax rate used here is the effective corporate income tax rate on a NIPA basis.
2. Latest data plotted is February 18, 1982.

If you look at interest rates plotted against the other extreme, plotted against last month's consumer price index, they look very high. But, you see, that kind of comparison has a lot of volatility in it, because interest rates change and because the consumer price index changes in the short run.

Nonetheless, I would agree with you that real interest rates, in any commonsense interpretation, are high, and I think they are high growing out of that experience of the past.

You talked about getting interest rates down to the 10- or 12-percent area. I would point out that they were at the 10- or 12-percent area—not for the prime rate but for market rates—in late October and early November. The trick is not just getting them down there for a month or two, but creating a set of conditions that will sustain a lower level of interest rates; and that is what we are trying to do.

There may be differences in judgment about how to go about that, but there is not any doubt or question in my mind that, to the best of our ability, we are conducting policies that more assuredly will bring that result—maybe not in the week or month that we would like—which will create an environment in which that result of lower rates can be sustained.

Senator **Sasser**. Well, Mr. Chairman, we hear talk now of a depression. Mr. Edward Yardini of E. F. Hutton & Co. is saying that there is a 30-percent chance of a depression coming now. He says that if this does not turn around by May, the chances of a depression go up to 50–50.

We hear the Chancellor of West Germany, Helmut Schmidt, an economist by training, saying that unless something is done about interest rates, we stand the danger of a worldwide depression.

I just want to ask you point blank, do you think there is a danger of this economy falling into a depression?

FACTORS DO NOT SUPPORT DEPRESSION

Mr. **Volcker**. I think the probabilities are very strongly on the side of recovery later this year. I think there is a question about the sustainability of that recovery, which has something to do with the budgetary problem.

I think there are risks on the other side; I would not characterize those as "depression." I think there are extremely strong supporting factors in the economy which we did not have in the 1930's, for instance. Government is very large, and whatever else we say about Government deficits, we are talking about projections of a prosperous economy when we are worried about these deficits.

We are not talking about the effects of a deficit in supporting income during a recessionary period as they are now. We have a tax cut coming along in June. If the economy were weak, you would expect, well within our present monetary targets, for pressures to be off the money market.

There are all kinds of supporting factors in the economy of a very basic sort that seem to me do not justify that kind of analysis. That does not mean that there are not risks that the recovery might not develop as rapidly or as strongly as we expect and anticipate. There are clearly risks on that side, and they revolve around the short-range movement of interest rates; I agree with that very largely.

Senator **Sasser**. One final, brief question, if I may, Mr. Chairman.

Mr. Volcker, if this Congress should just accept the President's budget as he has presented it and the budget deficit that that entails—he says $91.5 billion; our recalculations over here at the Congressional Budget Office indicate it would be closer to $140 billion.

IF ESTIMATES ARE CORRECT, MARKET WOULD IMPROVE

What is that going to do to interest rates?

Mr. **Volcker**. You made two different assumptions, I guess. If you took his budget——

Senator **Sasser**. If we just took his budget, period.

Mr. **Volcker**. If you take his budget, assuming that his estimates are correct of the impact, you have a deficit in the low 90's or high 80's, depending upon the year. I think that is probably a better outcome than the market now anticipates.

It is difficult to estimate the impact; it depends upon a number of assumptions. Looking ahead, you would be left with the Federal budget preempting a large proportion of the savings of the economy, but not an amount that is absolutely unprecedented for a relatively good year—not our best years—and within the range of historical experience.

I think if the outcome were, next year, a deficit of the size that the President projected and that was considered to be the right outcome and a fair estimate by the market, you would see improved conditions in the market.

Senator Sasser. If they believed the President's assumptions in his budget?

Mr. **Volcker**. If they believed it; that is right. You point out that the Congressional Budget Office estimates, with those same actions, a substantially higher deficit; the market is going to be looking at that, too.

Senator **Sasser**. My time is up, Mr. Chairman. Thank you.

Chairman **Domenici**. Before we let Senator Armstrong inquire, let me just correct the record. This is just a correction based upon the actual testimony. CBO's reestimate was——

Senator **Sasser**. It was 120, I believe.

Chairman **Domenici**. That 140 number is the 1985 number, but the President's is 91.5 for 1983. CBO's, with slight economic adjustments and spend-out changes, is 121, not 140.

Mr. **Volcker**. I would suspect that a lot of people in the market would not take exception to the CBO estimate, even assuming quite a lot of action, and that leaves you $25 billion above the administration estimate.

Chairman **Domenici**. Senator Armstrong?

Senator **Armstrong**. Mr. Chairman, as you have come up here day after day to testify before committees of the House and committees of the Senate, you might well reflect on something that Christopher Wren is supposed to have said to the effect that you may search all the public parks and you will never find a monument to a committee.

That is not in any sense related to your testimony, but as I sat here——

Senator HOLLINGS. How about the Rayburn Building?

Senator ARMSTRONG. Is that a monument to a committee?

Senator HOLLINGS. Yes.

Senator ARMSTRONG. Christopher Wren and I stand corrected.

BOLD MOVE PROPOSED

The thought that runs through my mind is really a fairly simple one. The two wisest and most distinguished members of this committee are our chairman, Mr. Domenici, and the ranking Democratic member, Mr. Hollings. They have both proposed a very bold move along the lines that you yourself have testified; that is, a big, big move against the deficit.

Now, they have proposed a slightly different kind of package, but the essence of it is this. I believe, in the case of Chairman Domenici mark, it would remove some $300, $320 or $340 billion from the projected deficits of the next 3 years.

I believe that it is the intention of those who favor such a plan—and I do not now just refer to my two colleagues, but to many of us who favor some version of a big move against deficits; not to wait for the passage of the budget resolution, but to move very quickly, and to do that either on the continuing resolution or to do it on the debt ceiling extension bill, or at the first opportunity that we have.

Whether or not we will be able to get the votes for something like the Domenici plan or the Hollings plan—Senator Gorton has a plan and Senator Boschwitz has a plan, and the common denominator of all of these different plans is that they are bold in the sense that they attack a lot of politically sacred cows and require quite a lot of courage on the part of Senators to actually vote for them.

Whether we will be able to get those votes really hinges on whether or not all of our colleagues think it will bring down interest rates quickly. So, I would like you to address yourself to this very direct question.

RESPONSE CAN BE EXPECTED FROM THE CAPITAL MARKETS

If we adopt some kind of a plan that credibly trims $2 billion or $300 billion out of the deficits projected for the next 3 years, can we confidently expect an immediate response from the capital markets? Will interest rates drop four or five points in 4 or 5 weeks?

Mr. VOLCKER. Four or five points? I think maybe that is asking more than I would want to estimate. I think you can expect a response, and a significant response. I am not going to quantify that at four or five points.

Senator ARMSTRONG. Mr. Chairman, I do not want to ask you to testify to more than you want to testify to, but I will just tell you that when it comes to getting the votes for that kind of a package, Pete and Fritz and the rest of us cannot whisper to our colleagues in the cloakroom, "You are going to get a significant response."

If Senators believe that there will be a four- or five-point drop in the prime rate as a result of that kind of a move, then we can get the votes, and there is not much doubt about that in my mind. If they have a strong reason to believe it, then the kind of policy basically that you are testifying in favor of can be voted on. But if they do not have that expectation or if it is hedged so much that they are not sure what they are going to get, I do not see how we get the votes to do. I really do not say that to put you on the spot.

Mr. **Volcker**. I understand your problem, but I am sure you understand my problem of not wanting to quantify an estimate. We have had fluctuations in these interest rates.

In the fall, the bill rate was, at one point, close to 10 percent; that was down 5 or 6 percent from its peak 6 months earlier. After that it went up 4 percent. Now, it is down 2 percent.

FOUR- OR FIVE-POINT DROP REALISTIC POSSIBILITY

Senator **Armstrong**. For those who claim that we would get a four- or five-point move in the interest rate as a result of such a dramatic budget breakthrough, if you were asked to comment on such an expectation, would you say that that was within reason?

Is it plausible, is it credible, or would you say that that was beyond the realm of what was a realistic possibility?

Mr. **Volcker**. I do not know precisely what budget program you are talking about; you have described a number of different ones. I do not know that I would want to suggest a decline in interest rates that big, and sustained, from that budget program immediately.

I think you can get declines in interest rates of that magnitude by a combination of policies, of which I think a disciplined monetary part has to be a part.

Senator **Armstrong**. We take it for granted that you will supply that.

Mr. **Volcker**. But I do not think the world is so simple that you can just pick out that one factor and say that, in the space of a few weeks or months, that is the kind of reaction you are going to get.

I think, with the big programs you are talking about, you would get a very strong reaction.

Senator **Armstrong**. Thank you, Mr. Chairman.

Chairman **Domenici**. Thank you, Senator.

Senator **Armstrong**. He said, yes, that that is the kind of response we would get. Let the record so reflect.

Mr. **Volcker**. I may have to correct the record in that respect.

Chairman **Domenici**. The record will speak.

Senator Exon?

Senator **Exon**. Thank you, Mr. Chairman.

Mr. Chairman, thank you for coming today. We are wrestling, of course, with what you are wrestling with—the high interest rate which basically is crippling our overall economy.

The middle of last summer, I and three or four other Senators wrote to you and the President about the situation with interest rates that was crippling the economy and, in essence, getting in the way of any chance for the President's economic recovery program to work.

UNITED STATES IN INTERNATIONAL SITUATION WITH INTEREST RATES

In response to my letter, you asked Vice Chairman Schultz then to come down and talk to us, and I thought he was very helpful. He simply explained to us that he had just returned from a trip to Switzerland and had visited with one or two Swiss bankers, and we should remember that we are not just in a domestic situation with interest rates; we are in an international situation with interest rates.

The Swiss banker basically told him that they controlled between $1 and $2 billion of traditionally long-term investment, and that was basically pension funds. But they were not, and he emphasized "not," going into the long-term bond market or any other type of securities until they could become convinced that the United States of America was going to get its deficit under control and therefore have some assurances that the investments long-term would not be eaten away by inflation.

In view of what has happened in the last 7 or 8 months, and in view of the President's recommendations to us, do you see any assurances from international bankers like that that they might be interested in coming into the long-term market again?

In the last 7 or 8 months, has that complicated and compounded the position of that international investor, or has he received some assurances?

Mr. **Volcker**. I have not talked to any international investors recently, but let me suggest that in these months since you wrote that letter, and since Governor Schultz talked to you and I talked to some of your colleagues, we have had two different things going on.

We have seen some real progress on inflation. I think there is a better feeling and more confidence from that standpoint. At the same time, we bave seen the budgetary situation, in a sense, unravel, in accordance with our worst expectations.

You have had two contrasting developments, and the budgetary situation has certainly put a damper on the optimism that might otherwise have been expected from what is actually going on with respect to inflation and, if I may say so, from a reasonably good record at keeping monetary growth under control.

You have not had as much confidence—I think the market displays that—as might have been the case if you did not have that budgetary problem looming ahead. I think that is what we are talking about this morning.

TRADITIONAL RELATIONSHIP BETWEEN LONG-TERM AND SHORT-TERM MAY RETURN

Senator **Exon**. From a traditional standpoint, short-term interest rates have always been somewhat less on a per annum basis than long-term interest rates; that has been the history. Do you see any chance of returning to that more stable relationship between short- and long-term interest rates if the President's budget proposals are accepted without change?

Mr. VOLCKER. I think there is clearly some chance. That relationship—higher long-term rates and lower short-term rates—has prevailed until recently, ever since the Depression in the 1930's.

There were long periods in our history where it did not prevail. It is not necessarily an act of God that produces that shape yield curve; you can have long periods of the opposite.

In periods of weak business activity, you certainly expect, normally, that kind of a yield curve. But I could see the possibility that if there were enough confidence, you could see long-term rates declining at least as rapidly as short-term rates for a while, particularly when we are in a position of restraining the supply of money, and compared to a situation of less restraint when you might expect to see lower short-term rates and a more positive yield curve.

When there is this much burden on monetary policy, you tend to get a flatter yield curve. But that, of course, would be corrected to a considerable extent by budgetary actions, not through their direct impact on the credit markets—which exist and would help the whole interest rate structure—but by taking some of the burden off of monetary policy; you would thereby increase the chances of getting the kind of yield curve you are talking about.

Senator EXON. Let me ask the question a little shorter so that maybe I can get an answer from you. My question was, if we accept the President's recommendations for this year and the out-years on the budget, are we likely to see as a result thereof any change in the fundamental, flawed relationship that I cited?

Mr. VOLCKER. I am not sure the relationship is flawed in that sense. But would you be more likely to see a rising yield curve? I think the answer to that is yes.

Senator EXON. My time is up, Mr. Chairman. I thank the Chairman for his answers.

Chairman DOMENICI. Thank you, Senator.

Senator Symms?

Senator SYMMS. Thank you, Mr. Chairman.

ECONOMY WOULD OPERATE BETTER BY REDUCING SPENDING

Chairman Volcker, I did miss your testimony; I tried to look through it, but from what you have said in the question and answer period, and particularly your answer to Senator Armstrong that it would be very helpful to the dilemma that we find the economy in because of high interest rates, especially in the interest-sensitive industries like the forest products industry and mining, and so forth, which are the mainstay of my State, interest rates could come down if we closed this margin on the deficit, and particularly those out-year deficits, I take it you are speaking of.

How much more helpful will it be if those deficits are closed by reducing spending as opposed to raising taxes?

Mr. VOLCKER. I am not sure it makes a great deal of difference in terms of the interest rate level, but it makes a difference in other respects. I think the economy would operate better; you would get better savings, you would get better incentives, you would get more investment, relatively, if you do the job, to the maximum extent possible, through spending rather than taxes.

Senator SYMMS. Well, I know there are numerous ideas floating around to do away with the proposed individual tax rate reductions and the business tax cuts. But is that not just going to put additional pressure on the financial markets from the standpoint that there will be less savings on one side and more borrowing on the other side?

Mr. VOLCKER. It might, depending upon whether it started with an equal amount of dollar savings on the budget deficit. I think the preferable way would be to go, just as a matter of economic analysis, in the other direction, to the extent possible; and, to the extent you raise revenues, I would try to raise them in areas that do not have those kinds of effects.

Excise taxes are one approach. The only problem with an excise tax is nothing comes free and easy in this world; you do have an impact on the consumer price index. Otherwise, that seems to me a desirable way to go.

FEDERAL RESERVE OPEN MARKET COMMITTEE INFLUENCES INTEREST RATES

Senator SYMMS. Mr. Chairman, I have had a lot of people tell me at different places in the country I have been this year that the Federal Reserve Open Market Committee really does regulate interest rates, whether you admit it or not publicly. Would you explain that to me, please?

Mr. VOLCKER. Explain to you why they think that?

Senator SYMMS. Well, why they think it or whether it is true or not. Is that true or is that not true?

Mr. VOLCKER. I think we obviously influence interest rates, but not in the sense that I often hear commented on, that it depends upon which side of the bed I get up on in the morning as to whether interest rates go up or down. That is obviously not a reasonable reflection of what we do.

What I think we are doing, fundamentally, is trying to create a climate in which interest rates will be lower, because over a considerable period of time, inflation and inflationary expectations are going to have a considerable amount to do with interest rates, even though the relationship is not good in the very short run.

The textbook analysis is that if we put more money in, interest rates will go down. That textbook analysis does not take account of expectational influences. That was true when the presumption of virtually everybody was that prices were going to be relatively stable and that you would be oscillating around some trend of low interest rates and inflation.

Once you upset that presumption, then the world gets turned topsy-turvy, and a lot of people act on the assumption that if they see more money being put in the market, that is going to mean higher interest rates in time. As they act on that view, you get a result opposite from the old textbook analysis.

We do have an influence on interest rates, but it is not a simple one of putting more money in and interest rates going down, or taking some money out and interest rates going up. I wish it were so simple.

Senator SYMMS. Just what does the Open Market Committee do?

Mr. VOLCKER. Basically, it decides whether to put more bank reserves in the market or not.

Senator SYMMS. OK. Now, in this computer world that we live in, is there any reason why we do not have more information for those of you making the decisions, to have a more steady—I know over the year, you have had somewhat steady money growth.

Mr. VOLCKER. We have had some fluctuations.

Senator SYMMS. Is it possible that that could be controlled? Should we not be releasing those figures once a week and doing it on a longer term period?

FLUCTUATIONS COULD BE CONTROLLED

Mr. VOLCKER. Let me take your first question first. Is it possible they can be controlled? It is conceptually possible, and probably practically possible, to control money more strictly than we do. I might question how far we could go without changes in the law and changes in institutional arrangements. But you also always have the question of how desirable that is.

There is a supply of money which we effect through bank reserves, and there is a demand for money which is the result of the decisions that everybody makes as to how much money they want to keep in the bank in a particular week or a particular month in the form of what we more or less arbitrarily call "money."

The question is whether every shift in demand schedule, technically, should be frustrated by our countermovement on supply.

We have had a lot of volatility in interest rates, but I think all economic analysis suggests you would have even more in the short run if we made the money supply in the short run more stable or rigid.

It is a matter of judgment. Is that a desirable trade-off? Have you gained much by having more unstable interest rates and a more statistically stable money supply? I am doubtful about how far you want to go in that direction.

I might just point out that virtually all foreign countries have a much more unstable month-to-month or quarter-to-quarter money supply than we do.

PUBLISHING MONEY SUPPLY FIGURES WEEKLY IS MISLEADING

As to whether we publish the figures every week, if I were operating anew and arranging the world to my liking, I would not publish those figures every week. There is a lot of statistical noise in them week to week, and there is something unhealthy about everybody in the world sitting waiting for the latest money supply figure in order to conduct their trading operations in ensuing days. The figure may not be very meaningful anyway.

But I am not starting the world from scratch. We do collect the figures. I think there is a presumption in the Freedom of Information Act that when we collect the figures we have to have a very, very good excuse not to publish them. And I think there is a presumption in the market that we publish them, so that they have all the information we do and can, hopefully, make better judgments about the course of interest rates and the economy than without them, even though, almost all the time, a particular weekly figure is misleading.

When you put the figures together over a period of time, you can see some patterns developing. We have struggled with the question for a long time. It is going to be on the agenda of the Board of Governors again in the next couple of weeks, and we will arrive at a new look and a new decision. But, obviously, we have not felt we had a compelling enough case not to publish them heretofore.

Senator **Symms**. Mr. Chairman, could I ask one more question that is right along this line?

Chairman **Domenici**. Sure.

Senator **Symms**. I am sure every Senator and every Congressman in the Congress has had people making suggestions to them that we should arbitrarily lower interest rates, pass a national usury law, or what have you. There are different suggestions being made.

I have been very surprised by some people for whom I have had a great deal of respect in their past pronouncements who have suggested this to me. I have always asked them the question, then, of who is going to get the credit.

I would like to ask you the question. If the Congress did call in the Federal Reserve—and I believe, technically, Congress does have control over the Federal Reserve—and arbitrarily lowered the prime rate, say, to 10 percent, is there any way that that could be handled and you could accommodate the money supply without having credit allocation or rationing?

CONTROLLING MONEY SUPPLY WOULD BRING RATIONING

Mr. **Volcker**. No. You would get rationing, assuming you controlled the money supply.

Senator **Symms**. We would have to ration it then?

Mr. **Volcker**. People forget about last year's problem very quickly. We did not have a system of that kind of control of the prime rate, but we had a rather elaborate system of controlling the rates that institutions could pay for deposits. Vestiges of that still remain, but basically institutions are free to pay market-oriented rates now.

Back in the sixties and early seventies when they were not, every time interest rates went up, these institutions were priced out of the market because they had an artificial ceiling. You had what was then known as a "credit crunch," and a credit crunch meant that the home buyer or the homebuilder and other people could not get any money since the institutions upon which they relied could not attract money because they had an artificial ceiling on their rate.

That was considered a very undesirable situation, and after living through a few cycles of that, most economists, most regulators, and most public officials of all sorts, and particularly those in the institutions, wanted to get rid of those regulations. They are still troublesome around the edges, but basically, in terms of the problems we had earlier, those regulations do not exist anymore.

You asked why interest rates are so high relative to what they were 10 or 15 years ago. I think it is true that we are now relying upon interest rates to curb the demand for credit in a way that we did not 10 years ago, because 10 years ago—not by design particularly, but de facto—you had this rationing process at work. So, every time interest rates went up—what appeared to be sharply then but is not very sharply by today's standards—people got rationed out of the market by lack of availability. Now, by and large, you have a situation where any creditworthy person can borrow money. He is going to pay a very high rate and he does not like it, and he may get rationed out of the market by the rate, but he does not get rationed out of the market by that kind of control.

The net result is that people are willing to pay higher rates to get the money, and that is part of the reason interest rates are higher now than they were 10 years ago.

Senator **Symms**. Thank you, Mr. Chairman.

Chairman **Domenici**. Senator Hart, we have three votes in a row. I think we have Nancy with a few questions.

Senator **Hart**. I just have two questions.

TRADITIONAL KEYNESIAN TAX CUT

Mr. Volcker, you said earlier that part of your relative optimism about at least partial recovery this year was premised on the additional tax cut that was coming forward. The theory behind that tax cut originally, as you know, as I understand supply-side economics, was that people would save and invest that money.

Now, I take it the theory behind the efficacy or the therapy of the tax cut economically is that it is going to stimulate demand; that is to say a traditional, if you will, Keynesian tax cut.

What if the supply siders are right and the effect of the tax cut is that people will save and invest that money rather than spend it? Will that make a difference to the recovery?

Mr. **Volcker**. If they both save and invest more, I think you would have some stimulating effects in the economy, but I would suspect the major effect to be on the spending side.

Senator **Hart**. So, what this tax cut is probably going to be is a traditional Keynesian tax cut to stimulate the economy in a recession rather than to stimulate supply by encouraging people to save and invest?

Mr. **Volcker**. It is the same tax cut.

Senator **Hart**. But the theory changed, did it not?

Mr. **Volcker**. Mine did not, at least during that particular period of time.

But I think you can get both over time: You can get effects of the higher disposal income stream and, at the same time, at the margin, have favorable effects on incentives to save and to invest and to work. In my judgment, that kind of effect is likely to be something that takes place over a period of time, but the two points are not in direct opposition to each other.

Senator **Hart**. My own view is that in the middle of 1982, if people get another $200 or $300 in disposable income, I doubt that they will spend $150 and invest $150.

Mr. **Volcker**. I think that they will spend most of it, but that has been the history of all individual tax cuts of that sort.

Senator **Hart**. Precisely.

Mr. **Volcker**. But, again, for a variety of other reasons as well, I would expect the savings rate to rise.

Senator **Hart**. It has been estimated, Mr. Volcker, by the House Budget Committee that about 75 percent, approximately, of the deficit this year is attributable to below-potential economic activity, the estimate being that essentially the $100 billion deficit would be about $25 billion if we had an unemployment rate of 6 percent rather than 9 percent.

If, in fact, one way to generate revenues is to put people back to work and people are not being put back to work because of the high interest rates, is not the policy sort of chasing its own tail here?

BREAK THE CYCLE BY DEALING WITH DEFICIT PROBLEM

Mr. **Volcker**. In a way, it may be fair to say from some perspective that we are chasing our own tail, which raises the question of how to get out of this kind of cycle.

I do not know about the exact numbers, but in order of magnitude I think the analysis of the current deficit is correct. The point to be made, I think, is that that is in sharp contrast to the deficits projected, let us say, in 1984 or 1985 and the years beyond. What is characteristic of these current projections which has not been characteristic in the past is that you would have a big deficit, even adjusting it for a 6-percent level of unemployment; the full employment budget, to use that terminology, is increasingly in deficit as these years pass.

Even if you assume a rapid and steady recovery, the deficits get bigger. What is true in 1982 is not true in 1984 and 1985, and that is what makes these deficits so disturbing. I would not be up here talking about the deficits in the manner that I am talking about them if we were simply projecting a deficit of the character that we have in 1982—a big deficit because of a recession.

We are projecting big deficits and rising deficits despite economic recovery. That, to me, begins to suggest the answer to your question as to how you get out of this kind of vicious cycle. Even if you could imagine that we could take actions by monetary policy or otherwise to push the economy forward, you would still be left with these huge deficits; and that says something about why interest rates are so high.

I think you break into this cycle or box that we have, logically, by dealing with that deficit problem. Traditional analysis in a stable world with stable prices says deficits are good for expanding business activity. I think we have the opposite now, because as it feeds back on today's expectations and today's financial markets, the outlook for those huge deficits in later years runs counter to the very recovery we want.

We have got to clear up this financial market congestion to maximize the chances for a health recovery. How do you do that? You do that in major part by acting on those deficits that lie out there in future years—not the 1982 deficit, but the deficits that lie out there in 1984 and 1985 and, transitionally, in 1983.

Senator **Hart**. Thank you.

Chairman **Domenici**. Thank you, Senator Hart.

DRAMATICALLY CUT OUTYEAR DEFICITS

Chairman Volcker, I think your last analysis is exactly right. Some are saying let us have a bipartisan approach and get on with reducing those deficits. I am not going to ask you to comment on this, but I am just going to share this with you. Some of us who want that to occur think that the easy way is to get rid of all of the tax cuts and balance the budget by basically increasing taxes, because there is a misperception that we have really cut all parts of the budget significantly.

Yesterday, I had occasion to recap what has happened to the entitlements programs in this country, and the truth of the matter is that they have been reduced by a very small amount. In fact, they are growing much quicker than the present rate of inflation, and most of them are compounding very dramatically.

It is my position that we have to dramatically cut the outyear deficits for the reason you have stated. It is almost impossible to get some people to understand that those deficits are predicted with solid economic growth. Now, that is almost a non sequitur. It may not happen because of the projections.

Mr. VOLCKER. Exactly.

Chairman DOMENICI. To the extent that they are credible and they are somewhere between the President's and CBO's, and maybe worse, you have deficits in excess of $100 billion in the outyears, when you are projecting rather good growth, a significant drop in inflation, a significant drop in interest rates, and all those indicators that the economy is humming.

It is in that regard that I think we are prophesying the demise of the recovery. That is the expectation that is being read out there. How can we build the economy back when reasonable projections show these kinds of deficits in real terms, which are rather extraordinary for the United States, and still expect those credible economic assumptions?

Now, there are those who do not believe the economic assumptions at all in any regard, and I do not know what to do about that. I mean, I would like to give them parameters of the optimum and the minimum, and say, "What would you believe?"

But I hope you understand that this Senator is not attempting to put together a package that bridges that gap instantly by getting rid of all the tax cuts. Quite to the contrary, I think we need a dramatic reduction in the budget before we look at the others.

My rule of thumb that I will just share with you today, even for 1983, 1984, and 1985, is in the neighborhood of $2 additional in budget cuts, credible and in place, for every dollar that you would look at in revenue-raisers of any type—the kind that you have discussed, the kind that are being bandied around by our leader or by Senator Dole or by anyone.

Does that basically square with your analysis of what we have?

Mr. VOLCKER. Yes. The philosophy that you express exactly reflects my concerns and what would be my objectives or my advice to you.

PUT MAXIMUM PRESSURE ON SPENDING

Chairman **Domenici**. Now, Chairman Volcker, it also appears to me that we ought to respond to those who want to just get rid of all the tax cuts, or significant portions, and bridge the gap that way, without significantly reducing the budget, or far less than I am suggesting.

Now, you have indicated to us to get the deficit down; the mix does not matter much. But could I ask you, in terms of a credible, sustained recovery, would not minimum budget cuts and maximum tax enhancement be a less desirable approach than the other?

Mr. **Volcker**. The desirable approach would be to put the maximum pressure on the spending, looking at it strictly from economic criteria. You have national security and other concerns, obviously, but from the standpoint of the recovery and the performance of the economy over a period of years, I think the emphasis on spending is the right emphasis.

I mentioned that the mix did not make much difference as far as getting the deficit down. I think from the total operation of the economy, it does make a difference, and to the extent you look at revenues, it makes a difference which revenue-raiser or loser, as the case may be, you look at.

Chairman **Domenici**. Thank you, Mr. Chairman.

We stand in recess.

[Whereupon, at 11:50 a.m., the committee was adjourned.]

AFTERNOON SESSION

VIEWS OF THE CONGRESSIONAL BUDGET OFFICE

TUESDAY, MARCH 2, 1982

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met, pursuant to notice, at 2:10 p.m., in room 6202, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Kasten, and Quayle.

Staff present: Stephen Bell, staff director; Gail Fosler, chief economist; Lizabeth Tankersley, minority staff director; and Kemble Stokes, chief economist for the minority.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Chairman DOMENICI. The hearing will please come to order.

Dr. Rivlin, you have appeared so many times before this committee that truly you need no introduction. The work of the Congressional Budget Office is absolutely essential to the mission of this committee and the credibility of its product.

This is our first hearing since the CBO issued its annual report last February 5, which included a lengthy and valuable report on budget reduction strategies. The CBO has also provided the Congress with an analysis of the President's budget and a brief report, performed at the request of Senator Hollings and Chairman Jones of the House Budget Committee, on the effects of last year's budget changes on American families by income group. I would expect all of these reports to be the subject of this hearing.

ECONOMIC RECOVERY REQUIRES REDUCTION OF DEFICITS

As you are aware, this committee will begin markup on the first budget resolution for fiscal year 1983 in just 3 weeks. Our budget actions are sure to be marked by controversy, but I hope that this controversy will not preclude consensus. Despite our differences on many matters, almost all of us on this committee want to reduce the Federal deficit substantially and consistently over the next several years.

I personally do not believe that we can have a long and substantial economic recovery in the presence of hugh budget deficits. I hope that your testimony will bear directly on this point.

COMPATIBLE MONETARY AND FISCAL POLICIES NEEDED

However, I also believe that our economic prospects for the next several years cannot be improved by a sharp reduction in the budget deficit alone. Clearly, as we discussed with Chairman Volcker this morning, we also need to have compatible monetary and fiscal policies.

U.S. ECONOMY LIMITED

The U.S. economy appears to be limited by several factors, not the least of which is the rapid increase in our defense and our international economic commitments. Even under the best of circumstances, I can see very intense competition for available capital to satisfy private investment requirements both in the United States and abroad. This will keep long term interest rates high.

For these reasons, I feel somewhat cautious about how robust the economic recovery will be, particularly if monetary policy remains restrictive. I believe that the economic forecast presented in the CBO's annual report is a prudent basis for this committee to use in making its budget decisions. It may be that the economy will perform better than the CBO predicts, and I certainly hope so. But to be responsible, we must make our decisions based on cautious forecasts, like the CBO's, and not on overly optimistic forecasts.

I hope that your testimony will focus on options for deficit reduction and on the economic effects of alternative strategies, particularly as they relate to defense, taxes, and entitlements. I do not need to tell you, Dr. Rivlin, how difficult is the task this committee faces. Your guidance this afternoon will be very important to us.

Senator Kasten, do you have any opening remarks?

Senator KASTEN. I do not.

Chairman DOMENICI. Dr. Rivlin, please proceed.

STATEMENT OF ALICE M. RIVLIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Dr. RIVLIN. Thank you, Mr. Chairman.

I will proceed as rapidly as I can. To aid the committee in the challenge ahead, the Congressional Budget Office [CBO] has recently submitted to the two Budget Committees our three-part annual report: Part I, on the economy, "The Prospects for Economic Recovery"; part II, "Baseline Budget Projections for Fiscal Years 1983-87"; and part III, "Reducing the Federal Deficit: Strategies and Options." Last week, at the request of the Senate Appropriations Committee we released a fourth document, "An Analysis of The President's Budgetary Proposals for Fiscal Year 1983."

The problem before this committee is to respond to the threat of huge and chronic budget deficits without adversely affecting the economy and without eliminating those Government services regarded as essential. In part, the deficit problem arises from the commitments made to raise the level of defense spending and to reduce the Federal tax burden. But the task of reducing the deficits to manageable size is also made difficult by the depressed levels of economic activity, by tight credit conditions, and, ironically, by reduced inflation.

My testimony today will cover four topics: The economic outlook, the Budget outlook, some major risks inherent in the administration's proposals, and budget options to reduce the deficit.

THE ECONOMIC OUTLOOK

Both the administration and the CBO anticipate an end to the current recession during the first half of this year, followed by a recovery in the second half. For calendar year 1982, the administration and CBO forecasts are in close agreement, as may be seen in table 1. In 1983, however, the administration's forecast for inflation and growth is more optimistic than ours. The administration looks for real gross national product to expand by 5.2 percent and for inflation, as measured by the GNP deflator, to fall to a rate of 6 percent.

TABLE 1.—COMPARISON OF ADMINISTRATION AND CBO ECONOMIC ASSUMPTIONS (BY CALENDAR YEAR)

	1982	1983	1984	1985	1986	1987
Gross National Product (GNP):						
Current dollars (percent change, year to year):						
President's February budget	8.1	11.5	10.2	9.7	9.2	9.0
CBO baseline	7.5	11.9	10.4	9.7	9.4	9.1
Constant (1972) dollars (percent change, year to year):						
President's February budget	0.2	5.2	5.0	4.7	4.4	4.3
CBO baseline	−0.1	4.4	3.6	3.5	3.5	3.5
Prices:						
GNP deflator (percent change, year to year):						
President's February budget	7.9	6.0	5.0	4.7	4.6	4.5
CBO baseline	7.5	7.3	6.6	6.0	5.7	5.4
Consumer Price Index (percent change, year to year):						
President's February budget	7.3	6.0	4.6	4.8	4.6	4.5
CBO baseline	7.5	6.9	6.9	6.4	6.0	5.7
Unemployment Rate (percent, annual average):						
President's February budget	8.9	7.9	7.1	6.4	5.8	5.3
CBO baseline	8.9	8.0	7.4	7.2	6.9	6.7
Interest Rate (91-day Treasury bills, percent, annual average):						
President's February budget	11.7	10.5	9.5	8.5	7.0	5.5
CBO baseline	12.0	13.2	11.3	9.4	8.7	8.1

Note: The administration's assumptions include the presumed effects of its new budget initiatives. The CBO economic assumptions are based on estimates of current policy taxes and spending.

The unemployment rate in the administration's forecast falls to 7.9 percent for the year as a whole, and the 3-month Treasury bill rate is expected to average 10.5 percent.

By contrast, the CBO expects real GNP to grow by about 4.4 percent in 1983, and the GNP deflator to rise by about 7.3 percent. The CBO sees short-term interest rates averaging 2¾ percentage points higher than does the administration. The slower economic growth expected by the CBO for 1983 is largely the consequence of higher real rates of interest in its forecast that serve to dampen the recovery in economic activity.

The administration's economic assumptions for 1984 and beyond are also more optimistic than the CBO's. Compared with the CBO baseline assumptions, the administration projects higher real growth, greater declines in inflation, unemployment, and interest rates. The administration's real growth assumptions for 1984 through 1987 are near the upper end of historical experience. In comparable 4-year periods following previous postwar recoveries, real economic growth averaged 3.4 percent a year and ranged between 2.0 and 5.2 percent. The administration assumes an average growth rate of 4.6 percent a year between 1984 and 1987. The CBO, in its baseline projections, assumes an average annual growth rate of 3.5 percent.

WEAK RECOVERY

In the CBO forecast, the recovery is brought about by the large tax cuts and the increase in defense spending, together with somewhat lower interest rates and declining inflation. The recovery is expected to bring a pickup in household demand for durables—particularly for housing and autos—and, in time, a boost to business investment. Nevertheless, the projected recovery is less vigorous than the typical cyclical upswing.

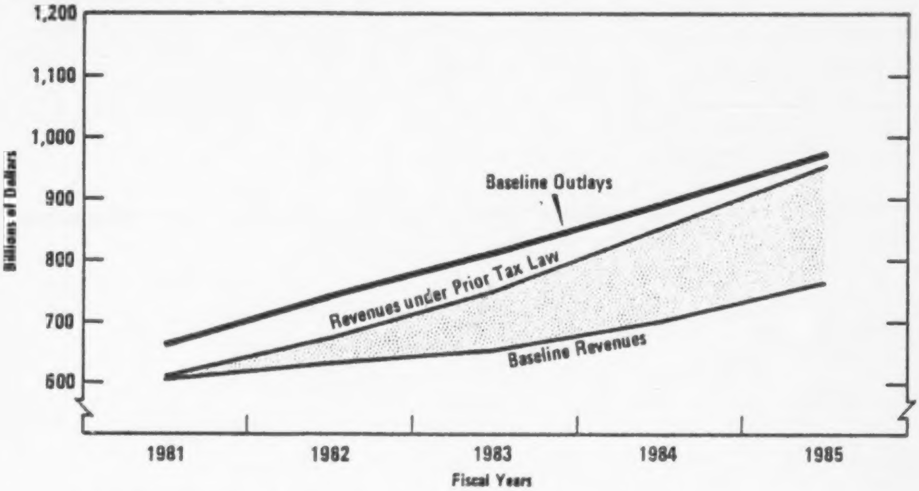
Why the weak recovery? The reason is that the Federal Reserve's targets for money growth would seem to leave little room for rapid growth in real economic activity. The Federal Reserve's targets are consistent with nominal GNP growth in the 7- to 11-percent range during the next 2 years. With inflation expected to be in the 6- to 8-percent range, the growth in real GNP is likely to be restrained relative to historical experience.

It is possible, of course, that the Federal Reserve will permit more rapid money growth, or that GNP will grow faster than suggested by historical relationships between money and GNP, or that inflation will decline much more rapidly than now seems likely—developments that might be associated with a more vigorous recovery. At present, however, the downside risks appear to be much greater. The major uncertainty relates to interest rates. Some forecasters expect interest rates to climb well above the levels assumed by the CBO, because they anticipate either that the Federal Reserve will pursue a more restrictive policy or that interest rates will be more sensitive to Federal deficits than expected by the CBO.

THE BUDGET OUTLOOK UNDER CURRENT POLICIES

The budget deficit for fiscal year 1982 is now expected to exceed $100 billion, almost triple the $38 billion target set by the Congress in its budget resolutions last year. Most of the increase over that target can be attributed to the current recession. What is unusual, however, is that the recession-induced bulge in the deficit does not disappear once the recession is over. Indeed, although the economy is expected to begin its recovery this year and move into a period of continued growth, budget projections by both the administration and the CBO show steadily rising deficits under existing tax laws and current spending policies. The reason for the widening gap between baseline revenues and outlays, shown in figure 1, is clear: The Economic Recovery Tax Act of 1981, which is expected to reduce Federal revenues sharply relative to GNP has not been matched by a corresponding reduction of Federal outlays relative to GNP.

Figure 1.
CBO Baseline Budget Projections



SOURCE: Congressional Budget Office.

ADMINISTRATION'S BUDGET PROPOSALS

The President's budget includes proposals designed to reduce the Federal deficit gradually over the next few years. About 80 percent of their effect would come from reducing spending below projected current services levels; only a little more than 20 percent of the deficit reduction would involve revenue increases. The cuts in spending proposed by the administration would affect almost exclusively Federal grants to State and local governments and spending on the day-to-day domestic operations of the Federal Government. Nearly 75 percent of the proposed net revenue increases during 1983–85 would come from higher corporate income taxes, offsetting about 60 percent of the corporate tax reduction enacted in the Economic Recovery Tax Act for that period. If the President's proposals are adopted, the administration projects that the deficit will decline from about $100 billion in 1982 to $72 billion in 1985.

CBO'S ANALYSIS OF THE PRESIDENT'S BUDGET

The Congressional Budget Office has analyzed the President's February budget and finds that revenues would be slightly lower than estimated by the administration for 1983–85 and budget outlays would be higher. This finding results from CBO's technical analysis of the administration's budget estimates and the substitution of CBO's economic assumptions for the administration's. The CBO budget reestimates are shown in table 2.

TABLE 2.—CBO BUDGET REESTIMATES, BY FISCAL YEAR

[In billions of dollars]

	1982	1983	1984	1985
Technical reestimates:				
Revenues	4.3	-5.2	-13.0	-15.6
Outlays	12.2	19.9	22.1	23.0
CBO's economic assumptions:				
Revenues	-3.4	-0.8	5.6	-4.9
Outlays	1.2	3.2	16.4	24.2

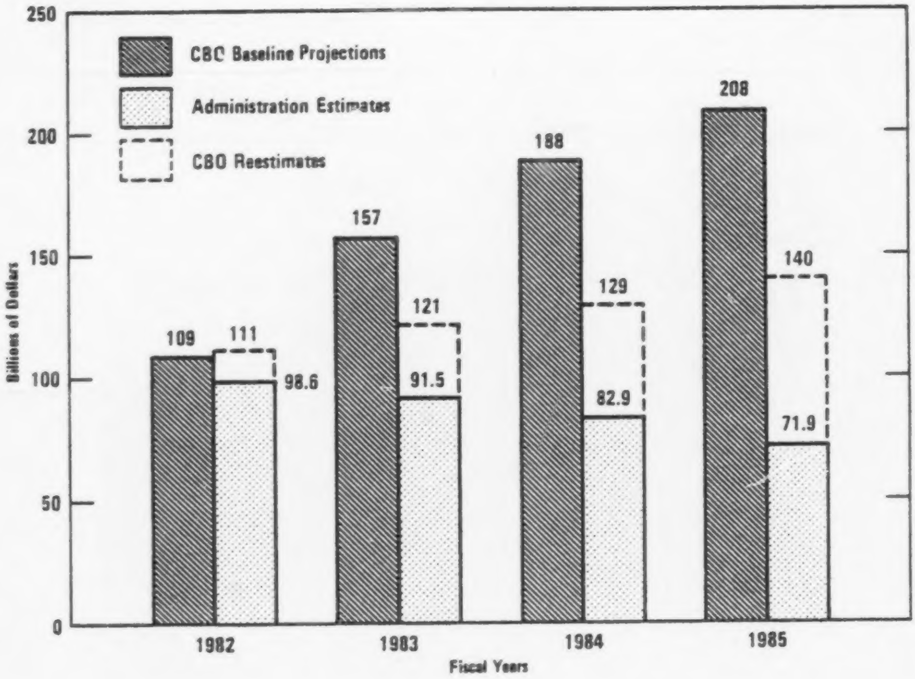
These reestimates produce a dramatic change in the outlook for the budget deficit under the administration's policy proposals. Instead of declining at a moderate rate, CBO's technical and economic reestimates suggest that the deficit would rise steadily from $111 billion in 1982 to almost $140 billion in 1985—almost twice the level projected by the administration. This result is shown in table 3 and is portrayed in figure 2.

TABLE 3.—UNIFIED BUDGET DEFICITS, BY FISCAL YEAR

[In billions of dollars]

	1982	1983	1984	1985
President's February budget	98.6	91.5	82.9	71.9
Deficit with CBO's technical reestimates	106.5	116.6	118.1	110.4
Deficit with CBO's technical reestimates and baseline economic assumptions	111.1	120.6	128.9	139.6

Figure 2.
Budget Deficits



The CBO technical reestimates for revenues result mainly from different estimates of the revenue effects of the 1981 Tax Act. The major CBO technical reestimates for outlays—which are shown in table 4—involve the cost of farm price supports, which have escalated rapidly in the last few months; likely receipts to be derived from the administration's plan to accelerate leasing of Outer Continental Shelf lands; net interest costs, mainly for servicing the higher deficit levels that would result from CBO's other technical reestimates; and defense outlays.

TABLE 4.—CBO TECHNICAL OUTLAY REESTIMATES, BY FISCAL YEAR

[In billions of dollars]

	1982	1983	1984	1985
National defense	3.3	1.9	1.6	1.5
Natural resources and environment	0.2	0.6	0.9	0.7
Farm price supports	5.1	5.6	2.7	2.4
Medicare	—	0.4	1.0	1.0
Social Security	1.0	0.9	1.2	−0.2
Other income security	0.5	0.8	0.7	0.8
Net interest	0.9	3.7	8.2	13.5
OCS offsetting receipts	0.9	5.2	4.8	3.2
Other (net)	0.5	0.9	1.1	0.1
Total	12.2	19.9	22.1	23.0

SOME MAJOR RISKS

Apart from the reestimates, there are several additional risks inherent in the administration's budget proposals. One is that the administration may have underpriced its projected defense appropriation requests. CBO has identified two major elements of concern in this regard.

First, inflation may not decline as rapidly as assumed for the administration's budget estimates. With higher than anticipated inflation, the administration would either have to scale back its planned defense purchases to stay within available funds or seek additional funds to complete the planned purchases. The CBO reestimates of the President's budget did not adjust the administration's projected budget authority for defense programs for the higher inflation contained in our baseline economic assumptions—that is, we did not assume that the administration would, in the face of higher inflation, hold to its purchase plans. If this were done, $61 billion in additional appropriations would be needed during the next 5 years to achieve the administration's real growth proposals.

Second, the real cost of defense purchases has grown in recent years—averaging about 3.5 percent per year since 1975. If the administration is unable to curb this cost growth, further funds would be needed to meet its defense procurement objectives. If the 3.5 percent average annual cost growth continues, for example, CBO estimates that an additional $48 billion in new budget authority would be required to fund major weapons procurement during 1983–87.

A second risk is that the administration may not be successful in meeting all of its targets for revenue increases and outlay savings from various management initiatives. CBO has not been able to develop its own independent estimates for outlay savings from several of these initiatives, particularly those that are clearly targets and are not allocated to specific budget accounts. The unallocated targets for reduction of waste, fraud, and abuse; for improved debt collection, and for the sale of surplus or underused Federal property total $16 billion over the 1983-85 period. Based on past history, these targets are very optimistic.

A more fundamental risk is the uncertainty in the economic outlook. The administration's program implies a strong fiscal stimulus in 1982 and 1983. The large budget deficits estimated by the administration and the even larger deficits projected by the CBO would result in a marked increase in Treasury borrowing that would put further upward pressure on interest rates. At the same time, the Federal Reserve's targets for monetary growth may act as a brake on economic growth during the next few years.

There is significant risk that the combination of a tight monetary policy and a stimulative fiscal policy could result in even weaker growth than projected by either the administration or the CBO. Since budget estimates are very sensitive to economic assumptions, policymakers must be prepared for the possibility of dramatically larger budget deficits if the economy fails to perform as well as in the CBO baseline.

SPENDING REDUCTION OPTIONS

Given the magnitude of the deficit problem, spending reductions in addition to those proposed by the administration will probably need to be considered. Defense spending and major entitlement programs cannot be left off limits if substantial progress is to be made in reducing the deficit.

DEFENSE

Large potential outlay savings could result from limiting the administration's proposed real growth in defense spending. The administration's proposed defense budget, according to CBO calculations, includes an average real growth in budget authority averaging about 6 percent a year over the 1982 to 1987 period, with an average annual growth of 9 percent in 1982 to 1985. As shown in table 5, reducing the real growth in budget authority to 3 percent a year over the 1982 to 1987 period would reduce outlays by $10 billion in 1983 and $53 billion in 1987. While the outlay savings are relatively small in the early years, they become much larger in later years.

TABLE 5.—OUTLAY REDUCTIONS FROM REDUCING AVERAGE ANNUAL REAL GROWTH IN BUDGET AUTHORITY (BA) FOR DEFENSE, BY FISCAL YEARS

[In billions of dollars]

Real growth in BA	1983	1984	1985	1986	1987
7 Percent	7	9	11	9	1
5 Percent	8	14	22	27	28
3 Percent	10	19	32	44	53

Note: Based on the President's February budget request, after adjustment for CBO technical reestimates and inflation assumptions.

ENTITLEMENTS

The administration's proposed budget for 1983 includes cuts in 18 entitlement programs, with an outlay reduction estimated by the administration at $11.7 billion. Over 60 percent of these cuts would affect means-tested programs—including food stamps, medicaid, and aid to families with dependent children—which account for less than 20 percent of total outlays for payments to individuals. The rest would occur in non-means-tested programs, including medicare, Federal civilian and military retirement, and railroad retirement, but not social security.

Much of the rapid growth in entitlement programs has been in retirement benefits, resulting from automatic cost-of-living adjustments. In the last 3 years, the Consumer Price Index—which determines most Federal COLA's—has risen faster than wages. Thus, retirement benefits have maintained their purchasing power, while wages of the working population have fallen in real terms. In addition, the CPI contains a flaw in its treatment of housing costs, which results in overestimating price increases during periods of rising home mortgage interest rates. Consequently, the CPI has risen faster than other price indexes during the last 5 years.

A change in the COLA's for retirement programs—social security, civilian and military retirement, and railroad retirement—could achieve large short-run savings. This approach would affect both current and new beneficiaries, thereby spreading the burden widely. Table 6 illustrates the estimated outlay savings from several options.

TABLE 6.—ESTIMATED OUTLAY SAVINGS FROM REDUCING COST-OF-LIVING ADJUSTMENTS (COLA'S) IN THE SOCIAL SECURITY, FEDERAL CIVILIAN AND MILITARY RETIREMENT, AND RAILROAD RETIREMENT PROGRAMS, BY FISCAL YEAR

[In billions of dollars]

Option	1982	1983	1984	1985	1986	1987
Automatic two-thirds of COLA with no discretionary supplement	1	6	10	16	23	29
Delay COLA from July to October	3	3	4	4	4	4
Skip 1982 COLA	3	14	16	18	20	21

Note: Changes in the COLA's for social security and railroad retirement are assumed to occur in July 1982, whereas changes for the Federal civilian and military retirement programs are assumed to occur in March 1983.

One potential change in the automatic COLA's in Federal retirement programs would reduce the adjustment to two-thirds of the increase in the CPI, with some or all of the remaining one-third granted at the Congress discretion. If this change were implemented, and no discretionary supplements were provided, savings would be $6 billion in 1983 and $29 billion in 1987.

REVENUE-INCREASING OPTIONS

Revenue-increasing options beyond those proposed in the President's budget could also be considered. Table 7 lists a number of possibilities, including scaling back the individual and business tax reductions enacted last year in the Economic Recovery Tax Act, and doubling existing excise taxes on alcohol, tobacco, telephones, and gasoline. Eliminating the scheduled 1983 rate cut and the 1985 indexing of the individual income tax would increase projected revenues by large amounts—more than $50 billion in 1985, and about $100 billion in 1987.

TABLE 7.—OPTIONS TO INCREASE REVENUES, BY FISCAL YEAR

[In billions of dollars]

Option	1983	1984	1985	1986	1987
Eliminate 1983 income tax rate cut	9	37	40	44	47
Eliminate indexing			12	30	51
Repeal safe-harbor leasing	3	4	6	7	8
Limit ACRS depreciation increase to 150 percent declining balance			3	14	19
Reduce ITC to 3⅓ percent for 3-yr equipment and 6⅔ percent for 5-yr equipment	2	4	6	8	10
Double existing excise taxes on alcohol, tobacco, telephones, and gasoline	10	12	13	14	14

Other options include increased energy taxes and broad-based consumption taxes, such as a value-added tax. A $5-per-barrel fee on imported oil would raise as much as $17.5 billion a year, although a large portion of that would be offset by lower corporate and individual income taxes. It would increase incentives for energy conservation and help to reduce U.S. dependence on foreign oil. A broad-based value-added tax could raise as much as $10 to $15 billion a year for each percentage point of the tax. If such a tax was substituted for part of the individual or corporate income tax, both of which impose a significant burden on saving, the overall burden of the tax system on saving would be reduced, thereby encouraging long-run investment and economic growth.

Another way of increasing revenues would be to reduce or eliminate some existing tax subsidies or tax expenditures, especially those that create perverse or inefficient incentives. An example is the employer-paid portion of health insurance premiums, which is now entirely exempt from taxation. Employer contributions to health insurance premiums could be included as taxable income in 1983 and indexed thereafter. Besides increasing Federal revenues by $2.6 billion in 1983 and by $8 billion in 1987, this option would be likely to narrow the scope of employer-provided health insurance, prompting people to economize in their use of medical care. Ultimately, this could help curb health-care costs.

Another possibility—and one that could raise still larger revenues—would be to terminate the deductibility of consumer interest payments. This deduction encourages consumers to buy on credit and discourages saving, particularly in times of high inflation. Ending this deduction would yield additional revenues of $1.2 billion in 1983 and $9.6 billion in 1987.

POLICY OPTIONS FOR IMPROVING THE BUDGET AND ECONOMIC OUTLOOK

In conclusion, Mr. Chairman, the outlook for the budget is grim. If the prospective rise in the Federal budget deficit were exclusively, or principally, a temporary cyclical phenomenon, there would be little cause for concern. Indeed, rising budget deficits during periods of recession serve to limit both the magnitude and the duration of the decline in economic activity. Once recovery is underway, the recession-induced bulge in the deficit shrinks as tax revenues grow and as outlays for unemployment compensation and related programs decline.

Unfortunately, the budget problem facing the Congress is not recession-related. It is, rather, a problem of continuing large and growing Federal deficits into the foreseeable future. No clear economic rationale exists for such deficits. Indeed, the persistence of very large deficits during an economic expansion could seriously impair the overall performance of the economy in the longer run. Unfortunately, the policy options available to improve the budget and economic outlook are not easy.

One option would be to encourage the Federal Reserve to adopt a more expansive monetary policy. This might result in a more vigorous recovery, particularly in sectors hard hit by tight credit conditions. Faster economic growth would also reduce the Federal deficit. But an easing of monetary policy, even moderately, might prolong the time required to achieve price stability; and a too rapid rate of increase in the money supply would virtually guarantee accelerating inflation.

A second option would be to enact further spending cuts and tax increases, or postpone tax cuts, to reduce the deficit. This would clearly reduce the risk of a conflict between monetary and fiscal policy, with the resulting "crowding out" of private investment. At the same time, however, it would slow the growth of GNP during the recovery period and require sacrifices on the part of many Americans that might be particularly onerous for those who have been adversely affected by the recession.

A third option would be to alter the mix of monetary and fiscal policy somewhat by adopting a slightly more expansionary monetary policy offset by further spending cuts and tax increases. This might result in both more vigorous growth in the long run and lower interest rates than might be otherwise expected.

Thank you, Mr. Chairman.

DOMESTIC BUDGET GROWTH

Chairman Domenici. Thank you very much, Dr. Rivlin.

Do you happen to remember in the decade 1970 to 1980 how much the growth in the domestic budget was, not including military? Is there some figure that would represent by what percent it went up from 1970 to 1980 or 1971 to 1981?

Dr. Rivlin. Not offhand.

Chairman **Domenici**. I do not have it in front of me.

Dr. **Rivlin**. I do not have it in front of me, either. The increase was very substantial, although as a percent of GNP it was not huge.

ENTITLEMENTS GROWING FASTER THAN INFLATION

Chairman **Domenici**. Your analysis of the entitlement changes recommended by the President are by specific program. Let me ask you, my figures would indicate that using CBO's February baseline, that all we have done to entitlements to this point is to permit them to grow for the next 5 years—from 1981 to 1985—at 11.2 percent.

Dr. **Rivlin**. That is about right.

Chairman **Domenici**. We have cut their growth about 2.8 percent in 1982-83 and 3 percent in 1984. Now, that means that they are growing much faster than inflation, unless we change it; isn't that right?

Dr. **Rivlin**. Overall they are growing at about the same rate as the gross national product. We have not cut the percentage of the gross national product that goes to entitlements appreciably.

Chairman **Domenici**. Yes, but that seems to be irrelevant for the next few years if we are going to get the deficit under control. We cannot keep using the same old comparisons unless we want to get rid of all the tax cuts that we have got.

Dr. **Rivlin**. That is right. Something has to come down.

Chairman **Domenici**. In terms of the most difficult part of the budget and in terms of its growth, if one assumes defense has to go up some, it cannot be coming down; are the entitlement programs the most logical source of congressional curtailment or restraint, based upon the figures that you have?

Dr. **Rivlin**. Clearly, yes, if only in the sense that they are the largest part of the budget. They are, roughly speaking, half the budget.

Chairman **Domenici**. And are growing fastest, outside of defense?

Dr. **Rivlin**. Yes.

Chairman **Domenici**. Growing by far in excess of discretionary appropriated accounts?

Dr. **Rivlin**. That is right. The cuts last year fell quite heavily on the discretionary appropriated accounts, and those have come down.

HIGH INTEREST RATES CONTINUING

Chairman **Domenici**. Let me ask you, in your chart, or in your projections of the President's and your CBO baseline GNP deflators versus your short-term interest rates, 7.3 percent in 1983 versus 13.2 percent, is that historically too big a disparity, or is that about right, historically? Do you have them back into perspective, as compared with this year?

Dr. **Rivlin**. It is a very high real interest rate.

Chairman **Domenici**. Still too high. Why is it remaining that way for so long? It is there now in spades; you are going to have that disparity improved somewhat, but it is still very high.

Dr. RIVLIN. I think the reason that the real interest rates continue to be high is in part that the Federal deficit itself is putting upward pressure on interest rates. There also may be an expectational effect—that people do not yet believe that inflation is coming down—which has kept the interest rates up over what they would otherwise have been.

Chairman DOMENICI. Would the expectation of interest rates going up be somewhat attributable to the expectation that would change monetary policy dramatically to accommodate the deficit, or is it really the other kind of inflation expectation? Which do you assume?

Dr. RIVLIN. It is probably a combination. I think people have begun to realize that Paul Volcker is very serious about a tight monetary policy, and the expectation is that, even in the face of high budget deficits, we will continue to have relatively tight money.

TECHNICAL OUTLAY REESTIMATES

Chairman DOMENICI. You have given us CBO's specific reasons for reestimating the President's out-year numbers aside from the economics. You have produced those in detail, have you not?

Dr. RIVLIN. Yes, we have.

Chairman DOMENICI. And they are available for the committee. We do not have to go over them today. What is the most dramatic interpretation of out-year outlays disparity that you have found, aside from economic assumption—what is the largest?

Dr. RIVLIN. The largest technical reestimates are listed in table 4 of my statement.[1] As you can see, they are fairly sizable in total. For the first several years, these technical reestimates dominate the economic disparities. The largest item for 1983 is our estimate for the farm price support program, which is over $5 billion higher than the administration's estimate. I think the administration now concedes that our number is probably right. We had later information than they did on which to base that. The other large differences include $5 billion for offshore oil leases. We are simply skeptical, based on the historical record, that the administration will come even close to its targets for revenues from the offshore oil leases. And we have some differences on the defense budget estimates, although the differences are somewhat less than last year. They have come closer to us in the defense budget. There are several other differences. Also, once we go through this exercise of making technical outlay reestimates, if they are on balance in the up direction, then we have to allow for the additional interest on that additional deficit, so that becomes another large item in the column.

Chairman DOMENICI. We have had a number of economists talk with us like Mr. Volcker—we have a few other witnesses yet to come. Can we have the economic recovery predicted in the President's budget with the deficits projected for 1983 and beyond as you project them?

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[1] See p. 310.

Dr. RIVLIN. That is a very difficult question. We have said yes, we think the economy can recover; but there is a very substantial risk that continuing deficits of the magnitude envisioned will put the brakes on the recovery. There is a risk, which a prudent Congress should avoid, that a rising deficit could abort the recovery. We do, however, see the economy recovering.

Chairman DOMENICI. Have you had an opportunity to exchange views, not necessarily on economic assumptions, but on the technical reestimates with the administration beyond the farm support, which you explained a moment ago? How about the others; have you had an opportunity to get their explanation and see what they say, so that when we mark up, we will have your version and theirs—but do you have anything more current than that?

Dr. RIVLIN. We do not have anything in writing. Our analysts and our cost estimators are in touch with the administration over these estimates quite frequently.

Chairman DOMENICI. Is your goal to attempt to reach some understanding on a majority of those?

Dr. RIVLIN. Our goal is always to reach understanding, so that we understand why they think what they think, and they understand why we think what we think. It is not necessarily to compromise the differences.

Chairman DOMENICI. But you will have those explanations brought current by the time we mark up?

Dr. RIVLIN. Yes, sir.

Chairman DOMENICI. Senator Kasten?

CONTINUING BUDGET DEFICITS NOT RECESSION RELATED

Senator KASTEN. Thank you.

You said, toward the end of your statement, that "Unfortunately, the budget problem facing the Congress is not recession-related. It is rather a problem of continuing large and growing Federal deficits." Particularly, isn't this large deficit recession-related?

Dr. RIVLIN. The level of the current deficit is clearly recession-related. Everybody's estimates of the budget deficit for the current year have gone up, since 6 months ago, as a result of the recession. But as we look ahead, even as we pull out of the recession, which we expect we will, there is still a problem of continuing budget deficits. These are not recession-related. That is the problem.

HOLD DEFICIT TO 2 PERCENT OF GNP

Senator KASTEN. What specific budget targets would you recommend that we aim toward in terms of deficits?

Dr. RIVLIN. It is very hard to give an exact number. We have all learned the hazards of setting a specific goal, whether it is zero or whatever. I——

Senator KASTEN. Unfortunately, we are going to have to set a specific goal within the next month or so.

Dr. RIVLIN. That is absolutely correct, one does have to set a goal. But it is difficult to tie oneself to balance in a particular year, because the economy is so uncertain. However, perhaps the minimum rule of thumb should be: as the economy recovers, the budget deficit ought to be coming down. Beyond that, one could think in terms of percent of gross national product. To hold the deficit to no more than 2 percent of the GNP, which is what it was last year, would again be a pretty stringent goal under the present circumstances, but would seem to me to be minimal.

DEMONSTRATE ABILITY TO CONTROL BUDGET

Senator KASTEN. You agree, I think, with most people who have testified before us, that what is critical now is that we demonstrate an ability to control the budget. We do not have to show a balanced budget, let us say, in 1984, or in 1985; what we have got to do is show the trend coming down.

Dr. RIVLIN. Exactly. I think the Congress has to have a budget in which the deficit can credibly be seen to be coming down as the economy recovers.

Senator KASTEN. And that means we have got to take out some of the fuzz in there with the selling of military surplus and those other kinds of things that you are saying. When you say "credibly"—you are kind of underlining "credibly", if I understand you?

Dr. RIVLIN. Yes.

Senator KASTEN. You said that you did not project growth. You said there was little room for growth, primarily because of the Fed policy and their slow rate of growth and the money supply. Now, last year, as I understand it, their targets were 3 to 6 percent, and they came pretty close to 3 percent—as a matter of fact, they were below 3 percent.

Dr. RIVLIN. The actual figure came under 3 percent, right.

Senator KASTEN. And my understanding is this year the targets are going to be 2.5-to 5.5 percent. Now we are really going to be in trouble if it turns out that we are close to that—or, do you believe that we are going to be in trouble if it turns out to be close to that 2.5-percent level?

Dr. RIVLIN. Yes, I do. The assumption in the CBO forecast is that they will be at the upper end of their target. Now, we made that assumption last year, and we were wrong. The actual figure came in below the target.

However, if I read Mr. Volcker correctly, it does sound as though he is more amenable to coming in at the high end.

Senator KASTEN. And if I read him correctly, he is saying that if we are able to put together a budget that can look controllable, that can start to demonstrate the deficit coming down, he is more likely to be closer to the high end. Is that the way you are interpreting what he is saying?

Dr. RIVLIN. Yes.

REEVALUATE INTEREST RATE FORECAST

Senator KASTEN. If we were able to put together a budget that showed some kind of control of entitlements and defense and many would be toward the high end, would you then recalculate the interest rate forecast on the assumption that interest would be coming down in the third and fourth quarter, and maybe the first quarter of next year?

Dr. **Rivlin**. Yes. If the deficit were clearly coming down, and if we are both reading Mr. Volcker correctly, then I think we would clearly have interest rates coming down.

Senator **Kasten**. So that you would believe that interest rates are coming down, and you would be able to reevaluate your forecast, your interest rate forecast?

Dr. **Rivlin**. Right.

TAX POLICY CHANGES

Senator **Kasten**. If we have a choice between different kinds of tax increases, or revenue enrichment or revenue enhancement or whatever we are going to call it, do you feel that we are better off taking away some of the additions onto the basic tax package? Are we better off dealing with questions like the leasing of tax benefits and some of the other kinds of additions, and leaving the tax cut in place? You said that changes in tax cuts or changes in tax policy would slow the economic recovery. Can I imply that we want to keep in place the business depreciation cuts and the 10-percent cuts the way they are, and concentrate on revenue enrichment or tax increases in other areas?

Dr. **Rivlin**. That is a very hard question, and I do not want to give a firm answer to it, because we never take a position on a particular piece of tax legislation, but——

Senator **Kasten**. I meant as an economist, in terms of the effect.

Dr. **Rivlin**. Certainly, one could make a very strong argument for looking at other kinds of tax changes, particularly as one looks down the road, for an economy that is low on productivity and short on investment. I think the general thrust of tax policy ought to be to move more toward consumption taxes and less toward income taxes—particularly taxes on the consumption of things that we have other reasons for wanting to discourage. That suggests that one might look at energy taxes, oil import fees, and general consumption taxes. One might also look at tax expenditures in the same light and consider such things as eliminating the consumer interest deduction.

MOVE UP TAX CUT

Senator **Kasten**. By moving up the tax cut from July to January 1983, wouldn't we help to propel ourselves out of this recession? By moving the tax cut up 6 months, and carrying your basic line one more step——

Dr. **Rivlin**. Moving from July 1983 to January 1983?

Senator **Kasten**. Moving the second tax cut retroactively to January would not help us. It's too late. But rather than waiting a whole year, what about the July 1983 cut taking place in January?

Dr. **Rivlin**. That would certainly give you a lot more stimulus. We expect, however, that the economy will be recovering by the end of this year, and that you might then not need the economic stimulus you would get by moving it up.

Senator **Kasten**. I do not know what the cost is of just moving 1983 forward, but at any rate, it would help propel us out of the recession. The question is inflation and some other questions.

Dr. RIVLIN. That is the problem. The problem is inflation and what it does to the deficit, and whether this gives you more trouble than it is worth.

DEFICIT TREND IMPORTANT

Senator KASTEN. But if we can get a handle on the expenditure side, we are not going to quarrel, I do not think, with a difference of $5 or $10 or $15 billion in the deficit, as long as the trend is right, isn't that correct?

Dr. RIVLIN. Yes, I agree. The trend in the deficit is really the important thing.

Senator KASTEN. So that there may be a choice between stimulus and getting real growth going?

Dr. RIVLIN. That is right. But the difficult thing at the moment is to figure out what the additional stimulus to the economy would cost in terms of the interest rate, which, if it is high, cuts growth.

Senator KASTEN. I do not have any further questions. It is my understanding that Senator Domenici had to leave. He asks that I leave the hearing open because some Democrats are expected to arrive.

Does anyone know if some Democrats are expected to arrive? I know we are expected to have a vote in about 3 minutes. I am told that Senator Hollings intends to be here, so what I would like to do is simply to recess the hearing for 5 or 10 minutes until Senator Hollings arrives. Does that work out for you?

Dr. RIVLIN. That is fine with me, and I will just stay until we find out whether he is coming or until he appears.

Senator KASTEN. Thank you very much for your testimony.

(Pause.)

Senator KASTEN. We might not have a 15-minute recess.

DIFFERENCE BETWEEN DEFICITS AND TREND LINES

Senator QUAYLE. I wanted to get an explanation of the difference between your deficits and the trend line going up and the administration going down. Has that been asked yet, and if not, could you fill us in?

Dr. RIVLIN. It has not been asked directly. The difference is two things, really. As we reevaluate the President's budget, we do see the deficits going up rather than down, even if the President gets everything he is asking for. There are two reasons for that. One is that we have somewhat different economic assumptions from the administration's.

Senator QUAYLE. What are those?

Dr. RIVLIN. If you have a copy of my statement, they are detailed in table 1.

Senator QUAYLE. I just got your statement and I have not had a chance to read it. OK. So, one reason the trend lines are different are the economic assumptions.

Dr. RIVLIN. That is right.

Senator QUAYLE. Is there one in there in particular where there is a big gap between you and the administration?

Dr. RIVLIN. No. In 1982, all the numbers are quite similar. In the subsequent years, we are just a little bit less optimistic than they are on everything, especially interest rates, which make a big difference in the deficit.

Senator **Quayle**. How much on just the interest rates alone? If you would assume the administration's interest rates, would that one factor alone change the trend line?

Dr. **Rivlin**. It might. It is certainly very big. The interest rates affect the deficit in two ways: You get higher outlays because there are higher interest rates; but also, because we are assuming larger deficits to be financed, there are additional interest costs. All of that adds up to a fairly substantial number.

To explore this a little further, take a look at table 2 of my prepared statement. What that shows is that basically, there are two reasons for the differences between the administration's budget estimates and the CBO's. The CBO economic assumptions lead to somewhat lower revenues in general, and substantially higher outlays, especially in the outyears. But there are also technical reestimates, where we differ from the administration for some reasons other than their economic assumptions. Those are several kinds of things. The main ones are listed in table 4. For example, we have substantially higher outlay estimates for farm price supports—$5.6 billion in 1983. That is largely as a result of having more recent information on the farm situation than the administration had when it put together its budget. We also have considerably lower estimates of the receipts from offshore oil leases, which appears here as increasing outlays. Based on the historical record, we are simply skeptical that the administration can raise that much revenue from the accelerated program of oil lease sales. There are other items there, and they add up to a fairly substantial number.

Then, the bottom line is given in table 3, which shows that, with the technical estimates alone, the budget deficit would rise somewhat in 1983 and then level off. But with the differences in economic assumptions added in, the deficit rises over the whole period.

PROJECTED 1985 DEFICIT

Senator **Quayle**. OK. By 1985, you are projecting a deficit of $139 billion.

Dr. **Rivlin**. Yes, roughly $140 billion, assuming——

Senator **Quayle**. And that is assuming the President gets how much in cuts in his budget?

Dr. **Rivlin**. That is assuming he gets everything that he has asked for in the budget, but as reestimated by us.

Senator **Quayle**. Now, what is the number of cuts in nondefense spending that the President is asking for? Do you know what that number is? Is it about $40 billion?

Dr. **Rivlin**. Roughly speaking, yes.

Senator **Quayle**. $40 billion over 3 years. Do your technical reestimates yield different results on that part of it?

Dr. **Rivlin**. We would have somewhat different estimates of the actual numbers, but we are not saying he will not get the spending cuts.

Senator **Quayle**. I know that, but the estimated spending cut for 3 years, I believe, is about $40 billion.

Dr. **Rivlin**. I do not know exactly what our reestimate of that number is, but I could provide it for the record.

[The following was subsequently supplied for the record by the CBO:]

The Administration's budget proposes 1983 outlays of $758 billion. The February budget document estimates that this level represents a reduction of $41 billion from a current services baseline for nondefense programs. CBO's analysis of the President's budget, which uses the CBO baseline projections as a starting point, indicates that the Administration's proposals would reduce nondefense outlays in 1983 by $33 billion. A major portion ($5.2 billion) of the CBO reestimate of lower savings is for OCS receipts, as shown in Table 4 of my prepared statement.

Extending this to a three-year period, however, provides a somewhat different picture. As shown in the following table, the Administration estimates that its nondefense spending proposals would reduce spending by $182 billion over the three-year period 1983-1985. CBO's analysis of the President's budget indicates that the nondefense reductions, measured against our baseline, would produce almost the same result for the three-year period.

Proposed Reductions in Nondefense Spending (By fiscal year, in billions of dollars)

	1983	1984	1985	3-year total
Administration Estimates				
Current services baseline with President's defense request	799.0	868.6	946.3	2,613.9
Nondefense reductions (net)	-41.4	-62.7	-77.8	-181.9
Proposed outlays	757.6	805.9	868.5	2,432.0
CBO Estimates				
CBO baseline with President's defense request	814.9	904.2	999.8	2,718.9
Nondefense reductions (net)	-33.4	-60.3	-86.6	-180.3
President's request reestimated by CBO	781.5	843.9	913.2	2,538.6

Senator **Quayle**. That is what I am interested in the reestimate of that. Is it higher or lower? He has specified where we are going to have those cuts.

Dr. **Rivlin**. That is right.

PROCUREMENT SPEND-OUT RATES

Senator **Quayle**. One other thing. Would you explain the technical reestimate on defense, in a little bit more detail? Just looking at this—and it is first blush for myself—you are talking in 1982 that there will be $3.3 billion more——

Dr. **Rivlin**. That is right.

Senator **Quayle**. You are saying $3.3 billion more in spend out under these estimates?

Dr. **Rivlin**. That is right.

Senator **Quayle**. OK, now, zero in. What elements in defense are we talking about that the administration is underestimating and that you are reestimating?

Dr. **Rivlin**. We are talking primarily about procurement spend-out rates, the rate at which the procurement accounts already appropriated spend out. We have been higher on that for some time, and it looks as though the accounts are spending out at about the rate that we estimated they would.

Senator **Quayle**. Are your procurement spend-out rates higher because of the inflation factor that was put in on the last budget resolution?

Dr. **Rivlin**. No. These are just estimates of the rate at which the same dollars will spend out.

Senator **Quayle**. Why is that? Do cost overruns have anything to do with it?

Dr. **Rivlin**. No. It is basically not a cost overrun problem. It is just the rate at which the contractors present their bills and the money gets spent out.

PROCUREMENT COSTS UNDERESTIMATED

Senator **Quayle**. Is it a historical pattern that the Department of Defense continually underestimates what their procurement costs are going to be?

Dr. **Rivlin**. Yes; they underestimate their procurement costs, but that is a different problem than the spend-out rates.

Senator **Quayle**. What is the difference between the cost and the spend-out rate?

Dr. **Rivlin**. Weapons systems have turned out to be more expensive in general. In fact, we have also given an estimate of what might happen if cost growth continues in particular weapon systems. But that is not the problem we are dealing with here. It is just the rate at which they spend out the money.

Senator **Quayle**. OK, you are talking about procurement spend-out rates.

Dr. **Rivlin**. Right.

Senator **Quayle**. Now, let me—I am trying to get this in my mind——

Dr. **Rivlin**. Yes; it is very complicated.

Senator QUAYLE. I know it, and I am trying to simplify it so that when we get into the defense aspects, and we are going to argue whether we are going to go with CBO or the administration or somewhere in between, that we will all know what we are talking about.

You are saying that $3.3 billion and—what does the total add up to here on the 4 years, real quick—about $8 billion underestimated in defense?

Dr. RIVLIN. That sounds about right; yes.

OUTLAY ESTIMATES BASED ON SPENDING PATTERNS

Senator QUAYLE. I want to know where it comes from. You are talking about procurement spend-out rates. Now, what are procurement spend-out rates? Is it just a pattern, as I said, where the Defense Department continually just underestimates these programs? Is it cost overruns? Do you anticipate that there will be more cost overruns like we unfortunately have had in the past? Where do we get this figure?

Dr. RIVLIN. Let me get Jim Blum, and see if he can make this clearer.

Mr. BLUM. Senator, these are largely analytical judgments that are based upon an analysis of how defense appropriations have spent out over the past. In addition, we closely monitor the actual outlays as reported monthly by the Treasury Department, so that we try to base our outlay estimates on the actual spending patterns that have been observed in the Defense Department in the recent past.

The largest differences that we have with the administration in the near term tend to be in the procurement area. There is also a major difference in 1982 and 1983 with respect to the operations and maintenance funds. Largely, the difference here is due to the difference in timing of a supplemental appropriations bill, as to when the outlays actually flow from that supplemental appropriations bill.

Senator QUAYLE. Do we lose money because the supplemental appropriations bill is held up?

Mr. BLUM. No; it is purely an accounting phenomenon as to what time in the year a supplemental appropriation is passed. If it is passed late in a fiscal year, most of the outlays from that supplemental will occur in the following fiscal year. For example, that is what happened last year with the 1981 supplemental appropriations bill. Last summer, there was a very large supplemental appropriation, basically for operation and maintenance activities. We judged that the spending of that would occur mostly in fiscal year 1982. The administration has also asked for a supplemental appropriation for fiscal year 1982. Underlying its estimates is an assumption that that supplemental appropriation bill will be enacted very quickly. We reached the judgment that, in all likelihood, it would not. It would occur at about the same time as it did last year, around July. Therefore, the spending from that supplemental appropriations bill would occur by and large in fiscal year 1983, rather than fiscal year 1982.

So there are a couple of things——

Senator QUAYLE. So what is the $3.3 billion?

Mr. BLUM. The $3.3 billion is an amalgam for 1982 of approximately a half billion dollars for operations and maintenance-type activities, about $3 billion for procurement, and about $100 million in the other areas where we think the administration has overestimated outlays. The net result is $3.3 billion.

For 1983, that aggregate difference narrows; it comes down to less than $2 billion. We still believe that the procurement activities are underestimated by the administration, but by less than in 1982. Here, we are talking about a difference of $1.4 billion. For the operations and maintenance activities, though, we think the underestimate is much greater than in 1982. This rests largely on the timing of a supplemental appropriations bill. On the other hand, we think other activities have been overestimated, so that we are talking about a net difference of less than $2 billion.

PROCUREMENT SPENDOUT RATES GETTING BETTER

Senator QUAYLE. Do the procurement spend-out rates get better in 1983? Is that the reason that that is about a billion——

Mr. BLUM. We think they are much closer to the mark. They are much closer to the historical patterns that we have been seeing, and we think that the data as they are coming in, reported monthly by the Treasury Department, substantiate our estimates.

Senator QUAYLE. You said that this supplemental is an accounting phenomenon——

Mr. BLUM. No; the outlays from which——

Senator QUAYLE. The outlays, then. But you are not saying that the way that we have supplemental appropriations on defense adds to the spend out, or the increase in the technical reestimates.

Mr. BLUM. No. It is only the timing of that. If an appropriation occurs very late in the year, then it is difficult to get the outlay effect of that appropriation in the same fiscal year. Typically, what happens is that the moneys will get obligated, and then it takes time for the work to be performed, the bills presented to the Defense Department, and payment to be made. So there is a time lag. The end of the fiscal year comes and goes, and those bills have not been presented. So that the outlays from that appropriation occur in the next accounting period.

PERCENTAGE OF INCREASE IN DEFENSE SPENDING

Senator QUAYLE. From 1982 to 1983, what is the percentage in nominal terms of increase in defense spending, as estimated by the administration and you? What kind of difference are we talking about? Are we just talking about a gap of $3.3 billion?

Mr. BLUM. That is right.

Senator QUAYLE. Now, if I recall, we went through this in the first budget resolution last year, and there was a gap in the defense.

Mr. BLUM. It was larger.

Senator QUAYLE. It was much larger because of the inflation factor.

Mr. BLUM. No. It was larger for two reasons. There was a much larger technical estimating difference between us—the same kind of difference that we have been talking about today. What has happened, in essence, is that the administration has come closer to our estimates. We really have not changed the way that we have estimated these programs at all. We have not changed our spending rate assumptions or the like. By and large, the administration has moved closer to our levels of estimates.

Senator QUAYLE. OK. So this time, we can say, as far as national defense, that the figures of the CBO and the administration are much closer.

Mr. BLUM. Are much closer together.

Senator QUAYLE. And we have still got to figure out—or, at least, I have got to figure out exactly what the procurement spend-out rates—I believe—if I could just summarize it, it really just seems like a pattern in the past that they just typically underestimate. Am I wrong in suggesting that?

Mr. BLUM. It is a problem that we have observed in other programs. I do not think I would single out defense in this case. I think what is happening in the procurement area of defense can be indirectly traced to the state of the economy. Defense contractors, when things are not going well in the rest of their business, can pay more attention to what they are doing for the Defense Department, and they tend to complete their work more quickly than they otherwise might. So they are presenting more bills for progress payments and the like than otherwise might occur if the economy were booming.

Also, because of the high interest rates that are present in the economy, defense contractors are very quick to collect their payments when they come due, and that could well have an effect of speeding up the spending.

Senator QUAYLE. OK. We will take your word for it. Thank you very much.

Dr. RIVLIN. Rather than entirely taking our word for it, if you are interested in going into this further, it is discussed at some length in this document, the Analysis of the President's Budget.

Senator QUAYLE. I will, because we get into this thing on the Armed Services Committee in particular, the whole procurement aspect, and the cost overruns, and the underestimates, and the reestimates, and supplementals, and it happens all the time, and some of us are trying to get a handle on it.

Dr. RIVLIN. It is complicated—so much so that we devoted a whole chapter to it in this document. If you would like further information, we would be delighted to talk about it.

MANAGEMENT INITIATIVES

Senator QUAYLE. OK, and maybe we could come up with some procedural remedies, also, that will remedy or take care of the situation where we always have this problem.

In the administration's proposal, they talk about management initiatives—I believe that is the word—or management adjustment, or something like that—of $15 billion.

Dr. RIVLIN. That is right.

Senator QUAYLE. Did you reestimate that, and where are they going to get all that?

Dr. RIVLIN. We only reestimated one piece of that, the offshore oil leases. There, we had some historical record to go on, and it seemed to us that they were overestimating receipts in fiscal 1983 by about $5 billion. So we have reestimated that in our document.

Regarding other management initiatives, however, we really did not have a basis to make a reestimate. The administration has put in fairly substantial amounts of money for sale of surplus property, for increased debt collection, and for waste, fraud, and abuse. That last category is not allocated to any particular program—it is not waste, fraud, and abuse in a particular program, but just waste, fraud, and abuse. We did not have any basis for reestimating those items, so we did not.

Senator QUAYLE. OK. Thank you.

There is a vote now. We will adjourn and find out if Senator Domenici or Senator Hollings will come back to close the hearing. We will beg your indulgence. I probably will not be able to come back, but Dr. Rivlin, it is always a pleasure to have you here. You are always informative, and I look forward to working with you.

Dr. RIVLIN. Thank you very much.

Senator QUAYLE. We will be in recess.

[Whereupon, at 3:45 p.m., the committee was adjourned, to reconvene Wednesday, March 3, 1982, at 10 a.m.]

VIEWS OF THE REAGAN ADMINISTRATION

THURSDAY, MARCH 4, 1982

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met at 10:16 a.m., in room 6202, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Boschwitz, Kasten, Riegle, and Exon.

Staff present: Stephen Bell, staff director; Gail Fosler, chief economist; Lizabeth Tankersley, minority staff director; and Kemble Stokes, chief economist for the minority.

Chairman DOMENICI. The committee will come to order.

Let me explain the budget process has, through the Second Budget Resolution, ordered the Budget Committee to report out the first resolution early. Almost every authorizing committee is meeting to send their recommendations out. So we are caught in the situation where almost every member is at two or three places at the same time.

I think we better get started because I am supposed to be at two meetings also.

OPENING STATEMENT OF CHAIRMAN DOMENICI

I welcome you to the hearings today. I am sorry that Dr. Jordan could not come, but we are delighted to have you.

HIGH INTEREST RATES MOST SIGNIFICANT NEGATIVE FACTOR IN ECONOMY

I have a prepared statement, but in light of the time constraints, I will insert it in the record. I would just say that, by way of opening remarks, that it seems to me that this committee has arrived at a consensus that the most significant negative factor in the economy is the high interest rates and that unless we can get them down and keep them down, the chances for economic recovery are rather slim; that is, sustained good recovery.

This has caused us to ask the question: What can we do with fiscal policy—in terms of fiscal activities to bring it down? I would say to the two of you that we have arrived very close to a consensus understanding. It is basically as follows: That, whether we use your economic projections or CBO's, in 1983, 1984, 1985 timeframe, we have extremely large deficits despite projections for significant recovery with lower inflation, low interest rates, higher employment, and lower unemployment.

MONEY LENDERS EXTRACTING BONUS IN TERMS OF REAL INTEREST

I think we have arrived at the conclusion that the money lenders of this country are extracting a bonus in terms of real interest because it is significantly higher than it has ever been with reference to inflation. We have concluded that this is so because they expect one of two things, either that we will continue to have the tight money policies and those big deficits, or that the Federal Reserve will eventually give in and dramatically loosen money causing a dramatic rise in inflation. We are, therefore, stuck with the proposition that we have to reduce the deficits in some way.

REDUCE FEDERAL SPENDING BEFORE LOOKING AT TAXES

Now, I would like to dispel any notion that either my proposal or Senator Hollings' proposal attempts to reduce this deficit by looking exclusively or even most significantly at the tax side. Quite to the contrary, I think there is a consensus that is epitomized in both of these approaches that says to further reduce Federal spending before you look at taxes and to reduce it by more than the President has recommended.

I think there are some misunderstandings about, instance, my proposal that asks for at least twice as much reduction in entitlement than the President's. Yes, it asks for some military reductions but, in proportion, the entitlement reduction is fourfold, over 4 years over the military reduction. The ratio being less than 25 versus over 100.

So I would say to you that it appears to me that we are talking about a different mix, and we are talking about both the effect of deficits that come from Federal spending that exceeds the revenues, and the effect that it has on the economy versus looking at a tax increase to breach the gap in terms of the costs that it takes out of the economy attributable to the Federal Government, be it spending or the deficits.

You have prepared remarks so obviously those can be read. I do not want to limit either of you, but I would appreciate it if you could summarize your remarks and then allow some questions. I am sure some Senators will arrive during the course of this hearing. If not, we will keep the record open for 24 hours and let them submit questions to you. We would appreciate your prompt response to them.

PREPARED STATEMENT OF CHAIRMAN DOMENICI

It is with great pleasure that I welcome to the Budget Committee this morning, Dr. Weidenbaum, Chairman of the President's Council of Economic Advisers, and Dr. William Niskanen, as a distinguished Member of the Council. I regret to hear that my friend Jerry Jordan, also a Council Member, could not also be here.

As you are certainly aware, this Committee will begin mark-up on the First Budget Resolution for fiscal year 1983 in just three weeks. At that time, we will consider the President's budget proposals.

PRESIDENT'S BUDGET REPRESENTS EXTRAORDINARY BUDGET PLAN

The President's budget represents an extraordinary budget plan for reducing the growth in federal spending spending beyond the levels achieved in last year's historic Omnibus Reconciliation Act. The President's budget proposes a substantial dramatic increase in the resources that this country devotes to military preparedness, which is an objective I have long supported, and proposes to balance these military increases by restraining the growth in domestic spending. Finally, the President's budget holds the line on tax increases, reducing federal taxes as a share of our national resources. Many on this Committee support each aspect of the President's budget and have voted repeatedly for specific legislation to achieve these ends.

MANY DISTURBED BY SIZE OF BUDGET DEFICITS

However, it should not come as a surprise to you that this Committee and many in Congress are disturbed by the size of the budget deficits recommended by the President. If these deficits were clearly cyclical in nature, the concern would be lessened. But they are not. They appear to be permanent and ever-growing, the product of spending and taxing trends that do not converge over time. These deficit trends indicate that we are not prepared to pay for what we want in this Nation and the present real interest rates in financial markets indicate clearly that this is a costly and potentially very dangerous strategy.

We are not economists. We are Senators. But I think we accurately reflect the concerns of our constituents when we anguish over the very serious consequences of large and repeated deficits and the high interest rates that accomplish such deficits.

I hope that your testimony this morning will help allay some of these concerns, and I look forward to your statement with great interest.

Chairman DOMENICI. Mr. Weidenbaum, you may now proceed with your statement.

STATEMENT OF MURRAY L. WEIDENBAUM, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS, ACCOMPANIED BY WILLIAM NISKANEN, COUNCIL MEMBER

Dr. WEIDENBAUM. Thank you, Mr. Chairman.

I would like to submit the statement for the record and turn immediately to the key questions that you have posed.[1]

This morning I am accompanied by my colleague on the Council of Economic Advisers, Dr. William Niskanen, and we will both try our best to answer the committee's questions.

The formal statement explains the nature of our economic assumptions, the basis for projecting an upturn in the second half of 1982, very strong growth in the second half of 1982 and beyond, and deals forthrightly with the serious deficits that confront us. We attempt to explain the impact of those deficits to the extent that we have special knowledge of the subject.

Let me begin by saying we are not here to defend large deficits. In my judgment, the economy would be in better shape if the deficits were lower. But deficit decisions are not made in isolation. They are made as a consequence of a variety of decisions about high priority defense and civilian spending, required entitlements, outlays and, of course, the need to maintain the tax program which we think is essential to the administration. The 1981 Tax Act obviates what otherwise would be an increase in the years ahead in the average citizen's tax burden.

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[1] See p. 361.

DEFICITS TOO LARGE FOR RECOVERY

Chairman DOMENICI. Mr. Weidenbaum, let me just ask you something now.

I have not read the entire statement of the Business Roundtable, which was published this morning, but it appears to me that they are saying whether the deficits are as predicted by the President or as predicted by the Congressional Budget Office, they are too large. They are big for us to have a recovery. They are suggesting that defense should be cut some and that taxes should be raised.

Now, in your opinion, what is behind that recommendation on their part? Why are they saying that?

Dr. WEIDENBAUM. I have not read the study.

I would guess, rather frankly, Mr. Chairman, that they might be sharing the point you made at the outset, which I think is universally shared, and that is those high interest rates are currently the key barrier to a strong sustained economic recovery.

But, very frankly, I do not think that the current deficits, as uncomfortably large as they are, will prevent the recovery in the economy. On the other hand, they certainly will not contribute to it.

To the extent that those deficits cause financial markets to increase interest rates, they are a serious problem. I think the deficits that have been presented, although uncomfortably large, are manageable.

Chairman DOMENICI. Well, what if, in the committee's judgment and in the judgment of the Senate as an institution, the best estimates of the deficits are not yours, not those submitted in the budget document? I believe that is what this committee is going to assume. Let me assume that with you and ask you if, after we have made the cuts recommended by the President, the deficits in 1985 are $140 billion instead of $72 billion and if the deficits in 1984 are proportionately that much higher than those predicted for 1983, are they too high?

Dr. WEIDENBAUM. Yes; but I am not saying that I concur with those projections.

Chairman DOMENICI. I understand.

Dr. WEIDENBAUM. If I were to concur with those projections, I would be urging further actions to bring the deficits down.

PROJECTIONS PRETTY FAR OFF

Chairman DOMENICI. You were part of, albeit you were not onboard very long, the projections given to us in the first budget submission from whence we took the cuts.

Dr. WEIDENBAUM. Yes, I was very much a party to the preparation of those numbers, Mr. Chairman.

Chairman DOMENICI. Now, I do not want to be unduly harsh because they were nothing but projections, and what you are talking about in terms of 1984, 1985, and 1986 are nothing but projections, and so are CBO's. But they were pretty far off the mark, were they not?

Dr. WEIDENBAUM. I am not prepared to say that. 1981 was the first year in those forecasts, and our economic projections for 1981 were very close to the mark; if anything, they were too conservative; that is, inflation in 1981 came out a little lower than what we said it would be. The growth rate came out a little higher than we said it would be, and the unemployment rate came out lower than we said it would be. So the 1981 projections——

Chairman DOMENICI. I understand that.

Dr. WEIDENBAUM [continuing]. Were quite good, frankly.

Chairman DOMENICI. I understand that. But you substantially changed 1983, 1984, 1985, and 1986 already, have you not?

Dr. WEIDENBAUM. The major change in the economic assumptions was in the calendar year 1982. The recession is longer and deeper than we had anticipated.

Chairman DOMENICI. I have an urgent call. I will be right back.

[Short recess.]

Chairman DOMENICI. Why do you not go ahead and proceed unless Senator Exon is on a tough time schedule this morning?

Senator EXON. Well, at 11 o'clock, Mr. Chairman, I would like the opportunity to go over to the Armed Services Committee where we are supposed to be reporting out whatever we are reporting in this committee.

Chairman DOMENICI. Why do we not let them go 10 minutes and then I will yield to you. I have to go to another hearing also.

Go ahead.

Dr. WEIDENBAUM. Mr. Chairman, I had just about completed my response to your last question.

I think, given the interest of the committee, rather than taking time to read the formal statement, the fact that it is in the record and it is available, I think meets our requirements.

Chairman DOMENICI. All right.

Senator Exon, do you have some questions?

HIGH DEFICITS CAUSING ECONOMIC TIME BOMB

Senator EXON. Yes, Mr. Chairman. I thank the chairman, and I am very pleased that you people have come to help us out this morning. I am sure that there are many members of the committee that would like to discuss the difficulties that face us with the chief economic adviser of the President.

Let me try and get to some bottom line considerations that I have, Mr. Weidenbaum. Let me just start out by saying that, in the opinion of this Senator, that the high deficits that are projected and the ones that we are dealing with right now, which, in my opinion, are causing the retention of the unrealistically high interest rates, are causing an economic time bomb that is ticking away louder and louder each day. And I wonder if the administration is listening, and if they are, are they hearing what is going on around the country? I get the impression that the President—who you advise—is simply stonewalling the situation that we have today.

You know, while this is all going on, the President is busily engaged out on the campaign hustings, saying that Republicans are not at fault; that he is only criticizing Democrats. Now, I say to you very plainly that that is a lot of political hogwash because the likes of the Business Roundtable and the American Bankers Association and those who control most of the financial institutions in this country, and the big businessmen are not replete with a large number of Democrats or outspoken Democrats in their ranks.

Now, what is the answer to all this? What are we going to do about it specifically? If you think there is concern, as I expect, as a reasonable man that you do, what do you think about the suggestion that has been made that because of the situation today, the President should take the leadership and call an economic summit at Camp David or elsewhere, to call in the leadership, both Republicans and the hated Democrats, to try and work out something along with the Fed, the money-market people, and well-known economists, and see if we cannot come up with a true bipartisan program to get us out of the economic dilemma that we are in right now. And I suggest that we are in an economic dilemma and, so far, the President has given no indication that he wants to do anything about it except stonewall.

Dr. WEIDENBAUM. Senator, as an economic adviser, not a political adviser, I would frankly say that I think there is as I look back at American economic history in the last decade, there is enough blame to go around in a truly nonpartisan way on both sides of Pennsylvania Avenue.

Senator EXON. So far we agree.

BUDGET NO PANACEA FOR HIGH-INTEREST RATES

Dr. WEIDENBAUM. But I have to tell you frankly as uncomfortable as I feel with high deficits, the key reason for those high interest rates that are so hurting the economy is not the deficits.

The major runup in interest rates occurred in a period between January 1977 and January 1981. The prime rate was about 7 percent in January of 1977. It was 20 to 21 percent in January 1981. Today the prime rate is 16.5 percent. That is very high. But it is a lot lower than 20 and 21 percent.

In fact, since the President has announced the budget for fiscal 1983, interest rates, short-term, intermediates, long-term interest rates have been coming down. If you compare interest rates 1 month ago with interest rates today of every maturity, they are high but not as high as they were just before the budget was announced. Therefore, I frankly do not think that the budget is the panacea to the high interest rate problem.

Having said that, I share the committee's concern, and it is obviously bipartisan; it has been expressed by you, Senator Exon, and the chairman, Senator Domenici, and other members of the committee. I share your concerns about the deficits and the budget but, very frankly, I am not enamored with the idea of an economic summit. Camp David is a lovely place but——

Senator EXON. Tell me about it.

BALANCE BUDGET AT LOWER LEVEL OF SPENDING

Dr. WEIDENBAUM. It is not where I usually spend my weekends. But I do not, very frankly, see this as a time for a lot of additional talk. I see it as a time for difficult choices.

Now, the President has submitted a plan which encompasses serious, serious budget cuts and significant increases in revenues, and we have said—I have said specifically, when asked about Senator Domenici's proposal, that we welcome the increased attention on the part of the Congress with the deficit question and a comprehensive program such as the Senator's is something we would and are seriously considering. But I think what we need, of course, is action, action to fundamentally slow down what has been too rapid the growth of government spending.

Very frankly, balancing the budget at an even higher and higher levels is not what the economy needs. Balancing the budget at a lower level of spending is what we need, and the key, I think, is to slow down what has been too rapid a growth in government spending.

TREMENDOUS PROGRESS MADE IN REDUCING INFLATION

As you know, the President recently met with Paul Volcker and the Council of Economic Advisers regularly meets with the Federal Reserve Board. There is a constant flow of communication, and as the President stated, we believe that their monetary policy is consistent with the administration's broader economic policy. Monetary restraint is the key to slowing down inflation and in bringing down interest rates. But there are several components to those interest rates.

One quite clearly is inflation and inflationary expectations. We have made tremendous progress in reducing the underlying rate of inflation for the past year. But real interest rates, what remains after you take out inflation is still, as the chairman pointed out, historically high. I know of no simple way of getting real interest rates down and, very frankly, I do not think it is in the ability of the administration or the Congress or the Federal Reserve or the private banking system in the United States to do so.

Incidently, those banks not only charge high rates of interest but they pay high rates of interest.

Chairman **Domenici**. Would the Senator yield?

Senator **Exon**. I have plenty more questions but I will be glad to yield.

LARGE DEFICITS REMAIN AFTER BUDGET REDUCTIONS

Chairman **Domenici**. Let me make an observation and ask either of you to comment.

You talked about the 1977 to 1981 era in terms of interest rates. There was an interesting situation occurring then. The Federal budget had turned from gradual growth, very small growth as President Ford left office to a 4-year episode with almost 16 percent growth in the Federal budget.

Now, the problem, I say to both of you, is that you are ignoring the fact that there is credible evidence that even with your reduced budget through 1985, the overall budget will not be on that kind of growth pattern and the deficits will be extremely large during that period of time. It seems to me you cannot have it both ways; that that extra deficit you have to fund is very similar to added growth on the budget side. We have not accomplished anything if, as a matter of fact, we have brought the growth in the budget down but have a proportionately higher deficit remaining after you have done it. I mean that is the dilemma we find ourselves in, and I would add a further remark.

You say you do not know how to bring them down. Now, I would say——

Dr. **Weidenbaum**. I am talking about real interest rates.

REDUCING DEFICITS NO INSTANT CURE FOR REAL INTEREST RATES

Chairman **Domenici**. I would say to you that Paul Volcker sat where you are as did three economists—Greenspan, Eckstein, and Galbraith. I do not know whether the good professors just got the mood of things or not, but all three were asked what would happen if you had a credible budget that reduced deficits in the range of $40 billion to $50 billion per year more than the President over the 3 years, most of which came out of budget cuts. Something in the range of two budget cut dollars per one on taxes. All three answered that if such a budget was in place, interest rates would start down and come down quickly. The only one that would not put any dimension to it was Paul Volcker because he was asked would it come down three or four. If you were in his shoes, you would not give any figures. I cannot quote his exact words, but it was pretty much "significantly come down and quickly." I think that is the thrust of his question to which you answered, you know, of no way. They have told us there is a way.

Dr. **Weidenbaum**. I believe from what you tell me, Mr. Chairman, there is no basic disagreement. They were referring to market or nominal interest rates and, yes, I think the perception by financial markets that the deficits would be sharply lowered in future years would reduce those inflationary premiums, would reduce perhaps market interest rates. But the underlining real rate of interest, that is a more difficult matter, I suggest, and part of the problem is we have world capital markets, and the United States is not the only country running deficits. In fact, we are a piker in terms of the ratio of the budget over the size of the economy to Japan or Western Europe. Japan last year had deficits that was about 40 percent of its budget. I am not saying that as an example. I am citing that as the problem that we face bringing down real interest rates when so many other nations are putting such great pressure on financial markets.

My point, and perhaps Dr. Niskanen could elaborate, my point is that bringing down the deficits, is a positive contribution, but it would not be an instant cure to the problem of high interest rates.

Chairman **Domenici**. I do not want to take any more time. I will get on Japan and Germany before you leave in terms of the relevancy of their deficits to ours.

Senator **Exon**. Mr. Weidenbaum, you just said that—in response to the chairman's question, that we are pikers as compared with some of our trading partners with regard to deficits. That fact, if it is true, and I have no reason to believe that it is not, because I think you are a truthful man, that fact was not enunciated very well by the President in the last campaign, was it?

Dr. **Weidenbaum**. I do not recall if he made such esoterical comparisons.

Senator EXON. I wish you had been invited then, Mr. Weidenbaum. Maybe——

Dr. WEIDENBAUM. I was working on regulatory matters.

Senator EXON. You were? But not on economic matters?

Dr. WEIDENBAUM. I was chairman of the Campaign Task Force on Regulatory Reform.

NO CLOSE RELATIONSHIP BETWEEN DEFICITS AND HIGH INTEREST RATES

Senator EXON. Now, did I understand you to say, in response to my earlier question, that you did not believe that there was any close relationship between deficits and high interest rates?

Dr. WEIDENBAUM. Yes.

Senator EXON. Yes what?

Dr. WEIDENBAUM. Yes. The economic literature does not show—this is a subject my colleague, Dr. Niskanen, has studied in detail—the economic literature, very frankly, does not show a close relationship between interest rates and Government deficits. That is just a fact.

Dr. NISKANEN. Senator Exon, with your permission and with the chairman's, I am prepared to summarize briefly what the empirical literature develops on this relationship.

All of us, I believe, are concerned about the magnitude of the deficits and all of us are concerned about the magnitude of interest rates.

I think that we should not expect to be able to reduce interest rates very much by reducing the deficits. That relationship is a much more tenuous relationship than is often presumed. And if you are prepared to provide a few minutes, I would be happy to develop one.

Senator EXON. Well, then, is this where the Chief Economic Adviser, other than Mr. Weidenbaum, to the President, Representative Jack Kemp came up with his now famed statement that the Republican Party now no longer worships the altar of the balanced budget? Is that part of the thinking of this administration?

Dr. WEIDENBAUM. Congressman Kemp is an eloquent spokesman for the district in New York that he represents.

Senator EXON. He is far more than that, Mr. Weidenbaum. He is a Presidential candidate or maybe a Vice Presidential candidate in the next election.

Dr. WEIDENBAUM. You appreciate we are economic advisers here. But, in any event, I assure you, Senator, not only do we express great concern about deficits but a major portion of our efforts during the preparation of the budget and the economic report was to advise the President on the specifics of slowing down the growth of Government spending, reducing the deficits. I know I personally have spent more of November, December, and January on specific efforts to get the deficit down than on any other single matter.

So to say that we are deeply concerned about deficits is an understatement.

CHANGE REVENUE SIDE IN OUTYEARS

Senator EXON. Mr. Weidenbaum, as the economic adviser to the President, did you advise the President during the preparation of the 1983 budget in the outyears that we are wrestling with here now, that some change would have to be made on the revenue side, or were you one of those that said stick to your guns, Mr. President, do not change? Above everything else, do not change the course that you are on, right or wrong, of escalating spending and deficits by billions and billions of dollars and reducing income on the other side?

Dr. **Weidenbaum**. Senator, I have two roles in this job. The second role I played today is to represent as best I can the administration that I serve.

The other role, my dominate role, is to serve as economic adviser to the President. And if I am to be effective in that role, the advice that I give to the President is a matter between the President and me, very frankly.

Senator **Exon**. So you cannot answer that question?

Dr. **Weidenbaum**. I think if I answered it in public, that would reduce my usefulness to the President as a confidential adviser.

BIPARTISAN CONSENSUS NEEDED

Senator **Exon**. The problem that we have, Mr. Weidenbaum, of course, and I recognize that you are sitting on that side of the table and I am sitting on another, but what I am trying to get back is to come up with some kind of a consensus, bipartisan consensus as to what we are going to do about the situation that we are now in. Since you have rejected basically out of hand, and since you rejected it out of hand, I am hopeful that maybe the President will reverse you and call the economic summit at Camp David to try to work out the difficulties that we have.

One of the problems that we have here time and time again is that listening to you and other spokesmen for the administration is that you say you are not a political adviser until we get some of the key questions on how we are going to straighten out the economy. Now, since you have made it quite clear that——

Dr. **Weidenbaum**. I have not rejected the summit. I gave you my personal view of the economic summit, Senator.

Senator **Exon**. Are you for or against the proposed summit meeting in advance?

Dr. **Weidenbaum**. I do not favor economic summits, but I repeatedly have stated that the administration is seriously considering the various comprehensive proposals, such as those by Senator Domenici and others.

DECLINE IN INFLATION AND INTEREST RATES ACCELERATED BY RECESSION

Senator **Exon**. Now, in your answer to my first question, you indicated, and I want to see if I can nail this down a little bit, that the administration was prepared to take credit for the rather dramatic turndown in the inflation rate and that the administration was prepared to take credit for what you describe as a rather dramatic turndown in interest rates.

Now, as an economist, Dr. Weidenbaum, would you not agree that despite the fact that the prime rate has come down from its high of approximately 21 percent to its present position of about 16 percent, that despite that fact, the real interest rate in terms of measuring that interest rate as economists traditionally do over the inflation rate, has not come down, but it has actually gone up in real terms?

Dr. **Weidenbaum**. Yes. And I was not claiming credit. I was just pointing out economic events that have occurred during this administration.

Over past years I have noticed if agricultural harvests result in price reductions, the administrative office is credited with that by its proponents, and if crops fail and prices go up, the opponents associate the administration in office with that. And very frankly I think most of what happens in this private economy results from decisions made in the private sector by the good Lord in the case of crops, and I think crowing is premature and, very frankly, some of the reduction in inflation that we have benefited from during the past year has been in the agricultural area. And I do not think it is a matter of credit or blame.

Senator **Exon**. Mr. Weidenbaum, as an economist, can you ever cite for the committee record a time when we had a serious downturn in the economy, a serious recession when inflation rates in America have not gone down or interest rates have not gone down?

My question is, Is not it assumed, with the severe recession that we are in today, that interest rates and inflation had no other way to come down, whether as a relationship to historic figures or not?

Dr. **Weidenbaum**. I would have to give you a yes but answer. The decline in inflation started before the recession, and the decline in interest rates started before the recession.

So, yes, recession did accelerate the downward movement, but it did not begin the downward movement.

AGRICULTURE, HOUSING, AND CONSTRUCTION DISRUPTED BY INTEREST RATES

Senator **Exon**. Mr. Chairman, one last question. You have been very patient. I appreciate it.

What is the administration going to do to attempt to rekindle the struggling housing and construction industry that, along with agriculture, is being seriously disrupted with interest rates? I have all but given up on any chance that this administration will recognize the difficulties in agriculture, where farmers are receiving depression-level prices for our products compared to the price of production, but at least there has been some hope that they might be beginning to do something about the housing market.

What can you tell us about the plans for the improved solvency of the thrift institutions and the beginning of new construction at least in homes?

Dr. **Weidenbaum**. Several points. First of all, continued progress on bringing down interest rates is the fundamental way of assisting the hard-pressed thrift institutions, the housing industry, our Nation's farmers, and all other segments that have been so hard hit by high interest rates, and we meet—I meet regularly with representatives of each of those organizations and, frankly, that is just what they tell me.

Now, in the housing area, as you know, the President recently set up a task force, an urgent high-level task force chaired by the Secretary of HUD, Sam Pierce. I am a member of that task force. We are meeting on an accelerated scale to develop our responses to the subject of the problems of the housing industry specifically.

Senator **Exon**. Can you tell us any proposals you are specifically considering at this time other than the general statements you have just made?

Dr. **Weidenbaum**. We just had our first meeting yesterday so I am not in a position to indicate which proposals we will be developing. But we are reviewing a wide variety of specific actions.

Senator **Exon**. Thank you, Mr. Weidenbaum. Thank you, Mr. Chairman.

PREDICTED SIZE OF DEFICITS TOO BIG

Chairman **Domenici**. Senator Riegle, I am going to deal with you in just 1 minute. I do not know that we are going to have anyone else so you will have as much time as you need.

Let me tell you that, on the issue of the predicted size of the deficits, I am sorry that the other Senators could not be here because I regret to tell you that I can see almost every face here as if they were present. I am afraid that it would not do any good for you to give your historic presentation because I think there is a huge consensus on this committee that the deficits are probably more in the neighborhood of what CBO predicts for a number of reasons, not only economic assumptions. There are five or six major items that on either the expenditure side or the recoupment side—the offshore leases, what it is going to cost for agriculture, and a number of others—that I just do not think it would do much good to attempt to say that deficits, such as $120 billion in 1983, $129 billion in 1984, and $140 billion roughly in 1985 are unbelievable. I think the committee has arrived at the conclusion that that is too risky to base policy on your numbers. Furthermore, we have concluded that there is a huge risk with the one thing we have, the American economy, and that we have to get the deficit down.

Now, I do not want to deny you the opportunity to address this issue, but I cannot put it any more simply. I think that is precisely where we are. I think the conclusion is that those are too big, in light of everything that we have heard, especially if you are predicting a growing vibrant economy and you still have those, and especially if you have reduced domestic spending substantially.

Now, if you want to respond, I would appreciate it.

Dr. **Weidenbaum**. I would quickly.

Obviously we live in an uncertain world, and as the President pointed out, all of these estimates are questionable. But under these circumstances I believe frankly we should error on the side of smaller deficits, not larger deficits, and that the administration is constantly reviewing its economic assumptions, and revenue estimates and will keep the Congress fully apprised.

As I say, I do not share those estimates that you have presented. If I did, I would be urging more budget cuts rather than less.

The points I have made repeatedly for months now is that in this period of recession, although uncomfortably large, the budget deficit for fiscal 1982 is manageable. But I think it is essential that in fiscal 1983 and fiscal 1984, as the economy pulls out of this recession, as we expect strong private credit demands, it is essential that we get the deficits down. That the 1983 deficits be substantially smaller than 1982; that 1984 be smaller than 1983, because that would demonstrate to the financial markets at home and abroad that we truly have the budget under control.

PRESIDENT RECOMMENDED REVENUE INCREASES

Chairman DOMENICI. One last question.

I know that you are quite properly saying to Senator Exon on the tax side that your private advice to the President is his business and your business, and I do not want to inquire any further other than to note that the President did recommend $34 billion in revenue increases. You do not disagree with that, do you?

Dr. WEIDENBAUM. I strongly support that.

Chairman DOMENICI. That in your opinion, some tax increases are not going to have a detrimental effect?

Dr. WEIDENBAUM. Not all. These are not tax rate increases. These are the loophole closings, extension of the tax base, improvements in the equity of the tax structure, improved collections. I think they represent a highly desirable way of reducing the deficits and I urge their support with great enthusiasm.

BUSINESSMEN SUPPORT BUDGET AND TAX REDUCTIONS

Chairman DOMENICI. Now, you can answer this if you would like. If you do not feel comfortable with it, I will understand.

You met with businessmen, they were among the strongest proponents of reducing the Federal budget and reducing taxes. Whether they believed in supply side economics or not, they believed that those two things ought to come down. Many of them do not believe in the theoretical supply side, but they understood that those two things were big drags on the economy. Many of those same people are talking to you now, are they not? You have met with them?

Dr. WEIDENBAUM. Yes, sir.

Chairman DOMENICI. We met with them.

Are they telling the President the same thing that they are telling you, in your opinion?

Dr. WEIDENBAUM. As you might suspect, the business community never was, and certainly is not monolithic today.

Some elements of the business community that have, to use your phrase, a more supply side orientation. These elements of the business community continue to be strong advocates of no tax increase of the budget, as we recommend, but quite clearly are there elements of the business community that want to see more done to reduce the deficit? I must say, however, that it is intriguing to note that the typical revenue increase recommended by the business community is in terms of the personal tax and not business taxes.

Chairman DOMENICI. Of course. I really was not addressing that singularly at any part of the budget, Mr. Weidenbaum. It has been my experience that the kinds of people telling us that these deficits are too large are indicating that they are probably going to be much bigger than predicted in the budget and that they cannot be assimilated either psychologically or really. It has been my experience that they are not telling the President the same thing they are telling us. It was in that context that I asked the question, and I do not expect you to answer it. I really wanted to make my point. I am making it to them as often as I can and, hopefully, they will be invited to talk to the President and discuss these issues.

I will yield to Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

Let me just say at the outset that I share the concerns that the chairman has been expressing. I would like to acknowledge the leadership that I think he is giving to the efforts to focusing this debate in a serious way, and it is not easy to do. It is certainly not easy to do if you are at odds with other important leadership figures in your own party. That is never easy regardless of parties.

So I have great regard for the efforts of the Senator from New Mexico along those lines.

Chairman DOMENICI. Well, I am more right this morning.

Senator RIEGLE. I am glad.

Chairman DOMENICI. It is—forget it.

FAMILIES AND INDIVIDUALS BEING CRUSHED BY PRESENT ECONOMIC CIRCUMSTANCES

Senator RIEGLE. Chairman Weidenbaum, as you know, you and I have a good personal relationship and it is something that I prize and value. And so what I am going to say ought to be seen as being separate and apart from that. I have a very deep concern about what is happening in the economy right now. It is a concern that is shared increasingly by, I think, an overwhelming majority of people across the country, in all sectors of the economy, and in both political parties.

Let me provide some quick statistics as a way of leading into my question.

I come from Michigan, as you know. The unemployment rate in the State of Michigan is at 16 percent and rising. We have 677,000 people in our State alone who are receiving unemployment compensation and it is estimated there are another 90,000–100,000 who we do not count anymore because they have exhausted their unemployment benefits. There are a number of companies, well-managed companies, which are going out of business and into bankruptcy. Representatives are coming to see me every day. They are companies of all sizes, very big ones, medium-sized ones, and small ones. The cascade of business bankruptcies across the United States is in the range of 500 a week and rising. Over 10 million people are unemployed in the country, and interest rates have received a plateau in the area of about 16½ percent for the prime rate.

But for people who actually have to borrow money to keep enterprises going, I would like to tell you the story of Eli Shinonous which is illustrative of the hardship of high interest rates. I know the President has a technique of using personal stories, letters or vignettes to demonstrate a point. I spoke recently with Eli Shinonous, a Chrysler dealer in Flint, Mich., with a large General Motors presence, Flint is not an easy place to be a Chrysler dealer in any circumstance. While he has been an effective dealer for years, he is now running out of money. When he goes to borrow money at the bank to floor plan the cars that he keeps in his showroom, he is not paying the prime rate. He is paying the prime plus 3 points. So he is not paying 16½, he is paying 19½, and he cannot survive. He is just one illustration of literally tens of thousands of people, whether they be in New Mexico or other States, who are in that situation.

Frankly, I see no value in crushing these companies, one after the other, large and small. These families and individuals are being crushed by the economic circumstances of the moment.

ADMINISTRATION'S BUDGET PACKAGE LACKS SUPPORT

Let me read to you a statement which appeared prominently yesterday in the Washington Post. This statement reads as follows:

> Prolonged high interest rates are creating an economic and financial crisis in this country. In order to bring interest rates down, immediate action must be taken to reduce massive Federal budget deficits. More than anything else, it is the specter of an overwhelming volume of deficit financing which haunts housing and financial markets and poses a threat of economic and financial conditions not seen since the thirties.
>
> Given these circumstances, there is no alternative to, one, choose slowing down all spending, not excluding defense and entitlement programs, and if necessary, two, deferring previously enacted tax reductions or increasing taxes. In order to have the necessary impact on financial markets, these actions should be taken prior to any increase in the ceiling on the Federal debt.

They are calling for this action quite soon. Who is it that put this statement together with its very vivid, very compelling description of the problem as they see it? It is signed by the American Bankers Association, the President of the Mortgage Bankers Association, the National Association of Homebuilders, the National Association of Mutual Savings Banks, the National Association of Realtors, and the U.S. League of Savings Associations.

What do we find in the paper this morning? The Business Roundtable has reached such a point of alarm that they, too, are calling for a basic change in the budget plan. I cannot find a single national organization of consequence that is today supporting the budget package that the administration has put forward. I cannot find a single Senator in either party here who is supporting the budget package that has been put forward. In fact, it is very hard to find anybody anywhere who supports it.

I know the President still supports it because he has made that clear in his speeches out West. Apparently there is a handful of others who still do. But the nearly unanimous judgment of serious economic and financial people in this country is that we are on the wrong track. There is a need for a major midcourse correction. We ought to do it now. Yet there is this seeming detachment from these realities. The President, and one presumes those immediately around him, remain detached from the true economic circumstances that exist in the country. Now, I find that hard to understand. It is almost impossible to reconcile. These organizations are expressing such a sense of desperation that they are buying full-page ads in the Washington Post and are using this kind of language to plead for a change in policy. Yet, it is as if none of this is going on. Everything is fine. We are right on track. The President is dug in. We are not going to make any changes. There will be no meetings, no discussions because everything is fine. I mean it is unreal.

ADMINISTRATION TOOK TURN DEALING WITH ENTITLEMENTS PROGRAM

Dr. **WEIDENBAUM**. Senator, I will tell you what I find hard to understand.

First of all, the lack of perspective. As I pointed out before you joined the hearing, these interest rates rose to these heights before this administration took office, and they have come down, not enough, they have come down since this administration has been in office. Now, that is the point that has almost been universally overlooked.

Point two, it is very interesting, and I welcome the growing concern about the entitlement programs, but let the record show that it was this administration last year that did——

Senator **RIEGLE**. How about this year?

Dr. **WEIDENBAUM**. That did this year—bear with me, Senator—that did present a serious proposal to deal with the largest entitlements, and rather than responding in any serious manner, I do not think the response to our serious proposal reflects great credit on the political process very frankly.

We took our turn in dealing with the entitlements program, now the Congress should take its turn to deal with the serious problem. I think the timing makes very good sense.

NEED FOR SERIOUS MEETINGS AND DISCUSSIONS TO INCLUDE THE PRESIDENT

Senator **RIEGLE**. I understand your point, but there is a sense of gravity in the country about our economic situation. There is a feeling of great urgency, that there is a need for some things to happen very quickly, to happen right now. Let me give you a couple of suggestions because I would like to see if they sound like they might be constructive and workable.

Dr. **WEIDENBAUM**. You understand we have made a couple of specific suggestions in the document, suggestions that would be constructive and helpful.

Senator **RIEGLE**. But, Mr. Weidenbaum, here is the problem.

If you take the budget document as a whole, it is unworkable, and that is a judgment of 100 Senators, and frankly, it may be the judgment of 435 House Members. I am not aware of any who are supporting it. All of these major national groups coming forward. It is difficult for them to do that, but they are coming forward and they are saying the same thing. You are sitting there alone. The President is isolated, and if you are holding the same rigid view, I think you are more isolated than it is good for you to be or good for the country to have you be. I would like to make this suggestion. I think there is a need for some serious meetings and discussions. I think there would be great value in having a series of private, frank budget discussions to include: the President and his chief economic advisers, like yourself; the key economic people on the Budget Committees and the Banking Committee of both parties in the House and Senate; and the Federal Reserve Board with its Chairman, Paul Volcker. I think there would be great value in convening some sessions of that kind without fanfare and publicity. These would be serious work sessions which can continue for hours on end, if necessary, where people can talk to one another.

This sense of reality that the rest of us have, in the sense of alarm that is so advanced that major and highly reputable national organizations are taking out full page ads. They are trying to penetrate into the inner circle of economic strategy with a new message. What could possibly be the harm of the type of meetings which I am suggesting? Is there not a need for some urgency in convening meetings of that kind?

Dr. **WEIDENBAUM**. I do not want to discourage you, Senator, from your current activity, but I need to point out the President receives orally and in writing a great variety of views, not only from those of us who serve on the administration, but from outside advisers, from a variety of outside interest groups, from the congressional leadership.

Senator **RIEGLE**. Let me ask you this question——

Dr. **WEIDENBAUM**. He is fully apprised and he, as you know, he recently met with Paul Volcker, again the Council of Economic Advisers keeps in constant touch. There is no shortage of——

Senator **RIEGLE**. How many times has the President met with Paul Volcker since assuming the office of President?

Dr. **WEIDENBAUM**. About four or five times.

Senator **RIEGLE**. I was told four.

Dr. **WEIDENBAUM**. I believe they missed the first meeting. I think the tally is five.

Senator **RIEGLE**. Do you know how long those meetings lasted?

Dr. **WEIDENBAUM**. It varied.

Senator **RIEGLE**. Can you find out for the record?

Dr. **WEIDENBAUM**. These were not perfunctory meetings.

Senator **RIEGLE**. That is what I am wondering.

Can you tell me how long?

Dr. **WEIDENBAUM**. An hour, or more typically.

Senator **RIEGLE**. How about the most recent meetings?

Dr. **WEIDENBAUM**. That was a one on one.

Senator **RIEGLE**. I know. But how long did it last?

Dr. **WEIDENBAUM**. I can assure you that these were serious meetings.

REDUCE DEFICIT TO GET INTEREST RATES DOWN

Senator **RIEGLE**. Here is the problem, Mr. Weidenbaum. Paul Volcker was here this week as a witness, and he was very frank to say to the committee that he feels that the budget really cannot work in the shape that it is in right now. He said if we want to see the interest rates come down, more has to be done to reduce the deficit. He was quite explicit about that.

Dr. **WEIDENBAUM**. But he was referring to the current services deficit, if I recall his testimony.

Senator **RIEGLE**. Let me refresh you on that.

When he was asked about what would it take to reduce interest rates at least 2 or 3 percentage points over the next 90 days, the goal that many of us have, he talked in terms of taking the outyear deficits in 1983 and 1984. The posted deficits in the Reagan budget are, in fact, lower than they are, which, if you adjust and put more assumptions in, but adjusting and putting more assumptions in, he felt that we had to cut $20 billion beyond that. That raises the defense budget and a variety of other things.

But my point is this. I think you need to soon recognize the importance of serious working sessions which have, in fact, not occurred. Let me give you an illustration, The Democratic side of the aisle on the Budget Committee would like an opportunity—I certainly speak for myself, but I think it is a generally shared feeling—at some point perhaps to discuss budget issues with the President. We have never done so. We have never been invited to do so. I think you are aware of that fact.

Dr. **WEIDENBAUM**. I am aware of the fact that the President frequently meets with Members of the Congress. I know I have been to more than I could keep a tally of.

BIPARTISAN PLAN NEEDED

Senator **RIEGLE**. Well, you have two problems, Mr. Chairman. You have a problem in which the President seems to have a hard time hearing what is being said. I am referring to comments about my Republican colleagues who do go to the White House with some frequency and who have talked to the President. They have tried to talk sense on economics, and they are finding it very hard to do. And they are coming out very frustrated according to the comments of Senator Dole, Senator Baker, and Senator Domenici. It appears that they are not having much luck in communicating their sense for the realities in terms of the way the President prefers to see things. It sounds to me like that may be a problem for you as well. I do not know because we have not gotten far enough into the discussion yet.

What I am saying to you is that I think we are at a point where we need a bipartisan effort. I think we need a bipartisan plan. Many of us want desperately to see the plan adjusted so that it can work, work quickly, to bring interest rates down so we can move people out of unemployment lines and onto the job.

But we are not party to any discussions of that kind. The President has not convened any meetings of that sort, it is rather unusual to think about doing so, but these are extraordinary times. This article yesterday, a full-page ad, is an extraordinary appeal. It is a cry for help. The Business Roundtable is saying to you today and the chamber of commerce, along with virtually everybody else, is that we are on a course that is not the right one. It cannot be sustained. The budget as it is put together needs to be changed. You can delay another 30, 60, 90 days facing these realities, but I am afraid the country is going to pay a very great price if you do that.

And I am appealing to you. I am appealing to you to see those realities, to see those facts, and to use what input you have to try to persuade the President that it is time to think about this in a different way. It is time to convene meetings of that sort. It is time to immerse himself and the chief economic advisers in a collective search for an answer on a bipartisan basis that may take not 1 hour or 2 hours. It may take several days running, it may take 4 or

5 weeks. I do not know how long it will take, but however long it takes, that is the most important work facing this country. It is not being done right now.

I am greatly alarmed by that. Most people I talk to are greatly alarmed by that. I am asking you if there is not some way that we can break this impasse, to seize this problem and work it out now?

ADMINISTRATION CONSIDERING COMPREHENSIVE PROPOSALS

Dr. **WEIDENBAUM.** Senator, you find someone here who is very sympathetic to your basic points and to the basic points made by those private organizations.

If you saw the 1981 performance of this administration, bipartisanship on both attacks and the budget side was the order of the day. We work with and expect to continue to work with the Congress in a bipartisan fashion. And I have said that the administration is seriously considering the comprehensive proposals such as those made by Chairman Domenici to deal with the serious problem of the deficit and of the budget and of the economy.

NATIONAL CHAMBER OF COMMERCE SUPPORTS BUDGET PACKAGE

Senator **RIEGLE.** Can you identify one major national organization that is supporting the budget package that has been sent up here in the form that it now exists?

Dr. **WEIDENBAUM.** I would like to—I cannot do that from memory.

Senator **RIEGLE.** Give it a try.

Chairman **DOMENICI.** You can supply it for the record.

Senator **RIEGLE.** You have got a friend here, but see if you can pull one out.

Dr. **WEIDENBAUM.** I believe the chamber of commerce, the national chamber of commerce has strongly endorsed the program of the President.

Senator **RIEGLE.** Let me yield to the chairman.

Senator **BOSCHWITZ.** What organization?

Dr. **WEIDENBAUM.** The National Chamber of Commerce of the United States.

Senator **BOSCHWITZ.** Bought your budget?

Dr. **WEIDENBAUM.** Believe me, Senator Boschwitz, I do not pretend to be a spokesman for the chamber of commerce.

SOCIAL SECURITY REFORM WILL OCCUR SOMEDAY

Chairman **DOMENICI.** Let me just say that I have to go to another hearing. Senator Boschwitz, you are going to preside.

I want to suggest one other thing and then you may conclude.

I think from the practical standpoint of how we get to where we have to be, it does not matter what history indicated. I think you have to give the President a budget that, within a reasonable period of time, based on reasonable assumptions, comes out balanced. Even though it probably would not occur due to the inaccuracies.

The reason I say this is that I do not think anything moves this institution as much as a very fixed goal. It appears to me that because we have the kinds of variables in deficits that we have, we cannot even project it out there to be in balance in the best of times with everything going and everything coming up roses. You end up with the effect, retroactive from that point, that is very, very devastating on the willpower. I know it would have been almost impossible with the policy assumptions that you made and all your savings are not in there. I have not heard any of you suggest that there will be social security reform someday. I am just suggesting that you ought to be talking about it. It will occur if, for no other reason, when it is bankrupt. It will occur, and it will cause less expenditures for years and less reserves. That is, it does appear to me that it has been devastating in terms of the effects that we are so far off in 1984 and 1985, given the parameters of error plus or minus $30 billion. If one takes the opposite view of you all, we are still at very high ones.

I am going to yield to the new chairman, and I do not think you were finished yet.

Senator Boschwitz [presiding]. Senator Riegle, before you continue, and since we proceed under the 5-minute rule, I know Senator Kasten has left another meeting to come here. Are your time constraints such that you want to go forward?

Senator Kasten. If you have a line of questions, you can go ahead.

Senator Riegle. Why do I not see if I can finish in a minute, and if I cannot, then let me stop and yield to you.

Senator Boschwitz. Go ahead.

RECESSION TO DEPRESSION UNLESS PRESIDENT'S PROGRAM IS ADJUSTED

Senator Riegle. Here is the problem that we face.

Unless the White House, the President and his chief economic advisers are willing to face the true economic realities that now exist and which all of these outside groups are bringing to your attention and are pleading with you to face up to, and for us to face up to, you are going to have the effect of paralyzing the process around here. We are not going to be able to work out the kind of budget we need. It will not happen. You cannot subtract Presidential leadership from the effort that it is going to take to work this thing through, to find the agreements and to make the compromises that may be necessary. You cannot do that without Presidential leadership. It is just not plausible. It will not happen. I think my Republican colleagues, at least privately, will say to you, and many will say it publicly as well, that it just cannot happen. It has nothing to do with parties. It would be the same regardless of whom was President.

I think you have a job in engaging the President in a serious, workmanlike way to help pull this process together. You are hearing in the most earnest way from Democrats that we would like to participate constructively. My State is being torn to pieces. I want to see us stop that destruction. We just cannot ignore these problems and have them continue month after month after month. It is dangerous to the country. That is why stories are running on the front of the Wall Street Journal which talk about the risks of depression. These are not isolated stories.

There was a major feature in the Wall Street Journal yesterday by Paul Craig Roberts, one of the original architects of Reaganomics, so far as I understand. He has now left the administration. The central argument of his piece is that unless the President's program is adjusted now and unless interest rates go down, we may go from serious recession to depression.

I think this is illustrative of the range of opinion and concern that now exists. The contradiction is that the White House seems to be all by itself in saying that things are just different than they are. The administration does not want to have to face and deal with those realities. We have to change that. I think you have an obligation to the President and to the country to help the President decide that this expression of alarm and concern is real. Time is short. He needs to be directly involved.

There are many of us here who want to participate constructively, but we need him involved in that process of believing that it is necessary. And right now there is no sign of that.

RECOVERY IS OVERWHELMING PROGNOSIS FOR PRIVATE SECTOR

Dr. **WEIDENBAUM**. Senator, let me assure you that in my internal role as economic adviser, I provide the President with as clear, as compelling, and as eloquent an analysis of economic events as I am capable.

But I have to point out that if I am to exercise my role as economic adviser effectively, the advice that I give to the President has to be a matter between him and me. So I am not at liberty to comment in any detail on the matters that you raised.

We should not, however, ignore the continued underlying strength of the economy. The prevailing view of private economists, in the private sector, is for the strong second half of 1982.

Now, in all candor, I have to point out that the extent to which interest rates stay high is going to weaken the prospects for a strong and extended recovery, but recovery is still the overwhelming prognosis for the private sector.

MAJOR ADJUSTMENT IN BUDGET NECESSARY

Senator **RIEGLE**. Well, I am going to yield to Senator Kasten, so he can have his opportunity.

In this morning's paper it is reported that the Business Roundtable has now taken the view that unless there is a major adjustment in the budget and in the economic circumstances, they do not foresee economic recovery coming until very late in the year. The fourth quarter is what is cited.

In the same report, it is indicated that the chamber of commerce is now dissenting, and feels that there does need to be a major reworking. You may or may not have seen that, or heard from them. But I would urge you to talk with them, and find out if it is accurate.

Dr. **WEIDENBAUM**. We never said that our program is set in concrete. We obviously made a variety of modifications last year, and I presume the program the President submitted to the Congress before it is enacted in 1982 will bear the impact of the Congress.

We proposed the program, and now the Congress is doing its constitutional duty of reviewing, and perhaps modifying.

Senator **Riegle**. I would just give you one statistic. The latest Heller-Roper survey found that out of 1,030 chief executive officers who were surveyed, 49 percent do not expect the recession to end before the close of the calendar year.

But let me not take up more time.

Senator **Boschwitz**. Senator Kasten?

EFFECT OF 20 PERCENT CUT IN MARGINAL RATES

Senator **Kasten**. If we had a 20-percent cut in the marginal rates in place today, rather than the 5-percent cut we have today, would we not be better off in terms of the economy?

Dr. **Weidenbaum**. There would be the effect of that difference, Senator Kasten.

First of all, assuming that social security increases would take effect, what would result, I think, would be twofold, a plus and a minus.

One, I think the recession might not have been as long, or as deep as it now is, depending, of course, on what the response of the Federal Reserve would have been——

Senator **Kasten**. You are worried about inflation, is that what you are saying?

Dr. **Weidenbaum**. Precisely, but inflation is predominantly a phenomenon influenced by monetary policy, not fiscal policy, in my judgment.

Senator **Kasten**. Well, the Fed came in at the bottom level of their target anyway. They came in below, a tiny bit below three, I might say. The target in 1981.

Dr. **Weidenbaum**. They may have followed a different pattern of monetary growth, I do not know.

Senator **Kasten**. With tight money policy at the Fed and a 20 percent cut in the marginal rates, you could argue that inflation might be a tiny bit higher right now. But clearly, economic activity would be greater because there would be more money available to the private sector, is that what you are saying?

Dr. **Weidenbaum**. But the key concern we all expressed this morning was on interest rates, and I am not prepared to say that interest rates would be where they are, or lower, if the Federal Government were running a larger deficit than it is today.

Senator **Kasten**. But the deficit today is recession related, not tax cut-related. If we did not have the recession we would not have the deficits that we have today, which is forcing those interest rates up. I understand we are talking chicken and egg here.

Dr. **Weidenbaum**. Quite clearly the recession has deepened the deficit, but we would never balance the budget in the absence of a recession. I do think the short-run effect of the tax cuts, which I strongly support, very frankly, is a lower level of revenues than if the taxes had not been cut, and if they are cut more deeply, the shortrun effects this year would be a larger deficit yet, and I think that would have an adverse effect on interest rates.

SPEED UP TAX CUTS

Senator **Kasten**. Along these same lines, would you support speeding up the July tax cuts for 1982 and 1983 to January?

The 1982 tax cut may not be worth the trouble, since we could not pass the change much before July. We would also end up with a lump payment, which would not affect incentives.

Would you reply specifically to speeding up the 1983 tax cuts?

Dr. **Weidenbaum**. I would not advocate either of those changes. If it is anything I have learned, it is stop and go policies are unproductive, they create more uncertainty in the financial market, and that is highly undesirable.

If there is any signal, I think we need to give, it is a steady, long-term tax policy, and that is why I have been urging staying the course, following the scheduled tax cuts enacted by the Congress.

LEASING OF TAX LOSSES FOR CORPORATIONS

Senator **Kasten**. Do you feel the same way about retaining some of the ornaments that were put on this tax Christmas tree? Specifically, how do you feel about the leasing provision or minimum taxes for corporations?

Dr. **Weidenbaum**. It is never popular to talk about measures that increase one's tax payments, but very frankly——

Senator **Kasten**. I think they were mistakes, and if we start with our basic program of 10-10-10, and accelerated depreciation we would be in a better position, but that is just my personal opinion.

Dr. **Weidenbaum**. There is a strong case, what we make some in the economic report for maintaining the leasing provisions so that companies and their regions benefit from the investment incentive, regardless of their current propositions.

I do think it is ironic that many parts of the country that have been hardest hit by the high interest rates, by the downturn, have ignored the fact that the leasing provisions benefits them especially, because it is where low-profit companies are clustered.

Now, there is another point here. So many of the people, and I share that concern, who are concerned about what we call a more concentrated economic structure, that is more and more mergers, again tend to forget that the leasing provisions reduces the incentives for large profitable companies to acquire other less profitable companies for tax purposes.

I think it is a very positive effect of the leasing provision. It is often overlooked.

FREEZE ENTITLEMENTS

Senator **Kasten**. If one of the plans that a number of the people on this committee have been working with comes over, it would definitely either freeze or delay the entitlements increases. It may be a change in the CPI, a delay of several months, or it may freeze all cost of living increases.

Will the administration support some kind of a change in the entitlements? They make up 60 percent of the budget, and we have not had any kind of direction, from either the economists or the politicians in the executive branch.

Dr. **Weidenbaum**. Sometimes it is hard to separate the two, I understand.

Senator **Kasten**. I was trying to make it so that you did not have to answer the question as a politician, you could do it as an economist.

Dr. **Weidenbaum**. I appreciate that, Senator Kasten.

Quite clearly, the administration has stated that it will seriously consider comprehensive proposals dealing with the budget, for example, those that are not limited to one specific part of a budget problem.

I do note that a number of proposals, including that of the chairman of this committee, that would deal in a comprehensive way with various parts of the budget problem, and we are giving those the very serious consideration that they deserve, but in the midst of this consideration, I am not prepared to say what we would conclude.

Senator **Kasten**. I thank you, Mr. Chairman.

BIPARTISAN EFFORT NECESSARY

Senator **Boschwitz**. Mr. Chairman, I am sorry I missed your presentation. I was flying back from Minnesota. Last night I discussed with the people in the Minnesota division of my company the fact that their division had a 34-percent reduction in sales last month.

The Milwaukee-Indianapolis division had a 37-percent reduction, Chicago had 32-percent reduction. So I take the whole business of the economy rather seriously.

I concur with many of the remarks I hear my friend from Michigan making. I know that his frustrations are predicated and based on the difficulties that he has with his State. I share those feelings.

I must say in defense of the President, Senator Riegle, that we on this side were not invited by President Carter to discuss the budget. As a matter of fact, some of the——

Senator **Riegle**. I am not sure that many of us on this side were, either. We both had that problem.

Senator **Boschwitz**. We have seen the President on this matter prior to his budget proposals. We look forward to a bipartisan effort, and we cannot accept on this side of the table, Chairman Weidenbaum, the idea that suddenly budget deficits are acceptable. That they are all right in relation to the gross national product.

You said in response to Senator Kasten, that stop and go policies are unproductive. I agree. The United States is not going to accept deficits as OK just because the deficit is a so-called normal percentage of the gross national product.

We are not going to accept that. We ran for office, as did the President, with a different concept and philosophy. We are adhering to it, and I hope the President will, too, and we will be back down to speak to him about it.

PROJECTED DEFICITS WILL KEEP INTEREST RATES HIGH

Senator Riegle spoke about outside groups who do not feel that continuing deficits are the thing to endorse. The banking community seems to concur. The banking community has decided that it doesn't believe interest rates are going to come down with the budget deficits that are projected and the resulting demands on the credit market. Even though the rate of inflation in the last 6 months has been perhaps at a 5-percent rate, there is a 10- to 12-percent difference between the rate of inflation and the basic rate of interest which people pay. We pay approximately a point above the prime rate.

So, Mr. Chairman, we are going to be heading for trouble together. We do not want to be heading for trouble, particularly on this side of the aisle, with our President, who we think has given us great leadership. But I ask you now that we come up with a budget that slows the growth of the various aspects of the budget.

Yesterday the Secretary of Defense spoke about the defense budget. He wants every penny that he asks for. He is not going to get every penny that he asks for. If we slow the growth in defense spending, entitlements and appropriated accounts, and if we change some of the entitlement authorization and project a balanced budget in a 3- to 4-year time frame, what would be the impact on interest rates in the country in the next 60 days, 120 days, 6 months?

Dr. **WEIDENBAUM**. In my personal judgment, that would have a very salutary effect on the financial markets and tend to bring down—I cannot pinpoint the amount, I do not think anyone really can but——

Senator **BOSCHWITZ**. I understand.

Dr. **WEIDENBAUM**. But I think it would tend to bring interest rates down, in my judgment.

INTEREST RATES HOLDING BUSINESS COMMUNITY AT BAY

Senator **BOSCHWITZ**. As I travel across the country and talk to people I find that one of the things, of course, that is holding the business community at bay is the high interest rates. My budget report begins by stating that if interest rates were changed to 8 percent tomorrow morning, within 2 weeks the economy would be humming, unemployment trends would be reversed, and optimism would be restored.

Dr. **WEIDENBAUM**. If I were young and handsome I would be a much happier man, but I think those are similar eventualities.

Senator **RIEGLE**. It is not so bad for you to be old and handsome.

Senator **BOSCHWITZ**. I am getting to like it myself. At least the older part.

But in any case, we do not have a spigot here that is labeled "interest rates" that we can turn on and off and lower and raise them at will. Interest rates are a function of the marketplace. And if we had such a spigot we should not stop after 8 percent, we should take it down to 6 percent or 5 percent. Many of the people who work for me have mortgages still at 5 and 6 percent from years past when interest rates were at that very acceptable level.

So what can the Federal Government do? We can increase savings and I think that the IRA rules that we have established have done that.

Do you have any figures on how that has worked, by any chance, either you or Mr. Niskanen?

IMPACT OF TAX CHANGE ON SAVINGS

Dr. **Weidenbaum**. No, we do not have a figure on the IRA's that just went into effect in January. But I can tell you this, the first 9 months of 1981 the personal savings rate averaged 5 percent. In the last 3 months, beginning October 1, the savings, personal savings rate was 6 percent. I think there are two factors at work. One was the reduction in inflation and inflationary expectations, it pays to save for a rainy day; but the second was the tax cut of October 1. So there is a good hope, I think, that policy can restore our currently depressed savings rate.

Senator **Boschwitz**. So you think what happened to the savings rate between October and January was a result of the 5-percent tax cut?

Dr. **Weidenbaum**. I think the IRA provision helped offset what would be the normal long-term drop in the savings rate following a tax change.

In other words, the initial impact of a tax change on savings tends to be much greater than the long-term impact, because consumers do not have an opportunity to change their consumption pattern quickly. So I do think that the savings rates will stay up at this nice 6 percent rate until it gets the big shot in the arm, July 1, with 10-percent across-the-board tax cut, then that will help get the savings rate up to 7 percent.

Senator **Boschwitz**. I have not looked at my own paycheck, but some people who work for me have said that the net effect of the 5 percent, and then the boost in the social security has been zip, $2, $3, or $4, meaningless.

Dr. **Weidenbaum**. But Senator, that means in the absence of tax cuts people would have less take home pay and I think that makes those tax cuts especially compelling.

INCREASED SAVINGS BASE DAMPENS CONSUMER SPENDING

Senator **Boschwitz**. Listen, I am a proponent of the tax cut. I am like Senator Kasten. I ran on it in 1978 saying that we have to slow the growth of Government spending. Not cut it, just slow down the increases in all areas. I am not willing, as the President is, to take on college loan programs and undermine the private education sector, or some of the other things that he wishes to do. As I said, it would be nice if we had a spigot labeled "interest rates" that we could turn off and on at will. We cannot.

So what do we do? We increase the savings base. That has a positive effect.

Frankly, when there is not additional money in the paychecks of a person and the savings rate increases due to measures such as IRA's consumer spending is dampened until that money is restored into the system through the lending and borrowing process. One of the other things that we can do is get the Federal Government and related agencies out of the money markets so that they are not borrowing such a large percentage.

Dr. **Weidenbaum**. Yes, sir.

BANKING COMMUNITY DOESN'T BUY CONTINUATION OF DEFICITS

Senator **Boschwitz**. But what the banking community has said and what these folks said yesterday in the full-page ad Senator Exon was waving at yesterday's hearings, is that they do not buy this continuation of deficits. I do not buy the continuation of deficits or the rationale that they are OK because they are a small part of the gross national product. I think the stop-and-go policies you mentioned are unproductive, and I think one of the things the banking community, and the business community is saying to us is that you cannot change suddenly.

Dr. **Weidenbaum**. Mr. Chairman, I assure you that this administration is very concerned about the deficits. It is precisely why we have a five-point program in the fiscal year 1983 budget to reduce those deficits.

CHANGE AUTHORIZATION TO BRING ABOUT BALANCE

Senator **Boschwitz**. We get a great deal of information up here from the Office of Management and Budget, the CBO and our own staff. If you ask three people, you get six opinions on what the deficits are going to be. But what is clear is that there is an enormous increase in the defense budget. I believe there has to be an increase but less than the President wants. My plan suggests about a 12-percent compounded rate of growth in outlays, not 16 as the President is suggesting. The military budget is about 24 percent. Interest payments are about 11 percent. The portions of the entitlement programs that are not being touched in your budgetary approach are approximately 27 percent of the entire budget. So if you add all that together, it comes to 62 percent of the budget. And then you want to try to balance the budget through reducing the remaining 38 percent of the budget. It is not a plan that we are going to adopt in this committee or, in my judgment, in the Senate. So we would hope that the administration will accept broader view of what has to be done to a broader segment of the budget. Again, I believe that we have to continue the philosophy of establishing as a goal a balanced budget within the foreseeable future. We must approach it by changing authorization across the board to continue the safety net but to reasonably change authorization so that we can bring about a balance.

Then in my judgment we can achieve lower interest rates and restore some economic vitality to the State of Michigan, to the State of Minnesota and as you point out, the areas where much of the stress is now being occasioned.

That is more of a speech than a question, Mr. Chairman.

I know I have spoken with Mr. Niskanen about these matters before but we are very intent and I am pleased that my friend and colleague from Michigan shares that intensity.

ADMINISTRATION DAMAGING ITS CREDIBILITY ON ECONOMIC ISSUES

Senator **Riegle**. If the Senator has concluded, and it sounds like he has, I might just say two things to him.

One nice thing about the end of committee hearings, when the press is gone and some members are present, is that there should be no mistake about the intensity and the seriousness of our feelings and how earnest we are in trying to convey to you what our reading of the situation is. It is very important that you understand that because something has to be done. I just want to make a couple more points.

I appreciate what the Senator from Minnesota has said because he brings important experience to this committee, not only from the vantage point of public service, but because of a record of success in the private sector which gives him an understanding of factors from that vantage point as well.

When I talked about bipartisanship, some of us here, in fact most of the Democrats in the Senate, had different ideas on the tax bill and offered a variety of amendments. Over 100 amendments were on the floor for 8 months. The overwhelming majority of the Democrats voted for the tax cut despite our reservations about parts of it. But we felt it was important to attack the problem of inadequate level of savings and to try to promote growth, economic growth, in the country. I think the majority of us continue to feel that way.

The objective facts tell us that we must do that. The world economy tells us that we must do that. There is an authentic desire to try to budget the economic situation quickly. There is a great sense of urgency. I say that by way of leading to this point. I think this administration right now is doing tremendous damage to its own credibility on economic issues and economic policy. You will not be able to repair easily or quickly if you stay on the tack you are on today. The President frankly is isolated with hardline views on the budget and on economic circumstances. Virtually all other serious financial observers who are not connected to the White House have broken away and in various ways are expressing great alarm. They are calling for a change in the mix of economic policy and are making concrete suggestions as to how it might be done.

To this point, the appearance is that all of that is being stonewalled.

Dr. **Weidenbaum**. Let me——

MEETINGS NEEDED ON A BIPARTISAN BASIS

Senator **Riegle**. No. I want you to respond, but I want to give you the full dose so that when you respond, you can respond to the whole thing. What we have to go on is what the President himself says. He has been making speeches and public appearances, commenting very forcefully and very pointedly on these issues. To some extent, he is even ridiculing many of us who are raising these concerns and who are offering to help in a bipartisan way.

In fact, the first sort of harsh response was directed at anybody who was raising questions, both Republicans and Democrats. That created friction and some phone calls were made. Within the last 24, hours the President has drawn a line. He said that when Republicans criticize the plan, that is all right; but when Democrats criticize, that is not all right.

That is nonsense.

Taking that approach is going to insulate the President further. I think it is going to damage the administration's policy. We do not need any of that. We are past the point. We have to approach a serious problem and we need to have some meetings commence on a bipartisan basis. Jim Wright has commented on it. I have commented on it over a period of time as have others. We need the President to be willing to sit down and be part of a constructive give and take that goes on perhaps for hours or days. We need to discuss these problems and to figure out how we might make necessary adjustments. Making very rigid, hardline and inflexible comments really is not only irrelevant, but beside the point. They ill serve the country. We have an obligation to try to fix this budget. If you did nothing more than to take this information back as best you can to the President, because it sounds like he does not like to hear these things, you will have done a great service. You work for him and you are presumably his most trusted economic advisor because you serve as his Chairman of the Council of Economic Advisers. It seems to me that you should be able to go back and say that things have changed, that there is a growing consensus in the country that some major adjustments have to take place. You should be able to tell the President that there is a feeling that he should participate as a central player, and that you are hearing from many people, Republicans and Democrats, who are willing to participate constructively in that process and that you think that it is time, Mr. President, that we do that. If you could decide, if you could reach the point where that was your judgment and that you felt that you could convey that judgment, I ask that you relay that to the President. I am not asking you to say today that it is or is not. I am just trying to help you move to that point because you are going to talk to him and the rest of us are not. I feel very strongly that that message has to be conveyed and you seem to be the most direct pipeline to him on this subject.

I think you would serve him well if you could convey that feeling convincingly enough that perhaps we could start a new process before more time is lost.

Dr. WEIDENBAUM. I thank the Senator for those observations. I hear you.

I am not here to discourage your concern about the budget deficit. Very frankly, I am pleased to note that there was a time within our memory, concern about controlling the growth of Government, about getting deficits down, was not as widespread as it is today.

I think that itself is a very heartening development. Now, we have——

TRIPLE DIGIT DEFICITS

Senator RIEGLE. I ask you to bear in mind the deficits above $100 billion; triple digit deficits frighten everybody. I do not know anybody who thinks that deficits on a continuing basis at that level are tolerable.

Dr. WEIDENBAUM. I do not think double digit deficits do anything good for the economy, either.

Senator RIEGLE. No, that is right. But in terms of the stark terror, once you hit triple digit deficits, and that is the projection as far as the eye can see, you are into a whole new world of unreality. I am saying to you there is a unanimous rejection of that path. It is a fact of life, and you ought to face it.

Dr. **Weidenbaum**. We have labored mightily to reduce the deficits, 1983, 1984, 1985. You see in the fiscal 1983 budget document the results. Obviously we welcome your support of those actions, five point program I referred to, and as I said, this is an administration that demonstrably, on a bipartisan basis, worked with the Congress in developing last year's tax and budget program, and hence, I anticipate that we will work again in a bipartisan way with the Congress to develop a program that will be ultimately approved by the Congress.

But the natural sequence of events is for the administration, in the office, to present its——

Senator **Riegle**. But you have been overtaken by events.

Dr. **Weidenbaum**. We are now in the process of reviewing the various congressional responses. But I hear you. I get your basic message, and I assure you I keep a steady flow of advice, as up to date as I can, to the President on economic matters.

COMPATIBLE SHORT- AND LONG-TERM OBJECTIVES NECESSARY

Senator **Riegle**. I would like to make one other suggestion. I think in revising the plan which needs to be done, that maybe the best way to start is from what you want to accomplish. I think you must have short-term objectives and long-term objectives, and they both have to obviously be compatible within the same plan.

I think your short-term goal ought to be to try to reduce interest rates at least 2 or 3 percentage points within the next 90 days. Start with that as a goal because high interest rates are caving in everything else you want to accomplish. Start with achieving that goal, and then work from there. Work from there in terms of the other things that you would need to do to enable that to happen. Talk to Paul Volcker about it. He has specific ideas as to how that could be brought about. He has been questioned at length by various committees on that issue.

Dr. **Weidenbaum**. We are in constant touch with the Federal Reserve. One of the reasons that we made arrangements to leave about noon today is that the Council of Economic Advisers and the Federal Reserve Board has its regular informal meeting.

WORKABLE PLAN COULD BRING INTEREST RATES DOWN

Senator **Riegle**. I would hope that maybe my question could be discussed. I think if you could come up with a modification of your plan that is workable, and if you could obtain support here and obtain it quickly, that would have the effect of bringing the interest rates down. It relates to Senator Boschwitz's point.

Obviously we are not going to reduce interest rates to 1 or 2 percent. But, by reducing them to the point where the wheels can start turning again, that actually will enable us to meet your objectives. We are not expecting an increase to 99 percent of plant utilization which is going to set off a huge spurt of inflation.

Dr. **Weidenbaum**. I must say that interest rates have come down in the month of February.

Senator **Riegle**. Sixteen and one-half percent, with 2½ points above prime. If you think that is coming down, then you are deluding yourself. Maybe that is where you are going wrong. Is the fact that they have come down to 16½ percent, an indication that we are out of the deep woods?

Dr. **Weidenbaum**. No, but I am aware of the strategy in previous years that drove up those interest rates, and very frankly, I think it is vital to avoid repeating the strategy that drove up those high interest rates.

Senator **Riegle**. Well, I agree with that, but frankly I do not think that is the issue.

Dr. **Weidenbaum**. So many of the suggestions that we have received boil down to either an easy money policy, or subsidies for various groups, which would only worsen the deficit, and only exacerbate the current situation.

Senator **Riegle**. Is the bottom line that there is no way in the near term to reduce interest rates?

Dr. **Weidenbaum**. There is a way.

Senator **Riegle**. Well, then let us put that on the table. The budget that is in front of us has been looked at from that point of view. I am frank to say to you that the virtually unanimous judgment is that that budget document does not achieve that objective.

Dr. **Weidenbaum**. I would be happy if the deficits were lower. If you could responsibly reduce those deficits, the blessing is on you.

Senator **Riegle**. Senator Boschwitz?

Senator **Boschwitz**. You have to be somewhere, what time, Mr. Chairman?

Dr. **Weidenbaum**. I was counting on leaving about quarter after.

Senator **Boschwitz**. Fine. We will get you out about that time.

Senator Reigle, I want to tell you that I do not think 2 or 3 percentage points are enough.

Senator **Riegle**. I agree; they are not enough. But they are better than what we have now.

RESTORE LONG-TERM LENDING IN MARKETPLACE

Senator **Boschwitz**. Of course interest rates have come down since last August, quite a bit. But they have come down by the amount they recently went up. So we have not made any gains.

It is not enough for interest rates come down two or three points, because it is not going to bring about long-term lending, which is absent in the marketplace at the present time.

The only thing that is going to bring about long-term lending, in the beginning of a recovery, are those sectors so importantly affected by long-term lending——

Dr. **Weidenbaum**. But the total economic policy, I would suggest, monetary and fiscal——

Senator **Boschwitz**. I understand. I compliment the Chairman of the Federal Reserve for his continued diligence, and it is more than just a budgetary policy. This body can impact on economic policy through the budget, and that is, of course, why we are so adamant in this regard.

We have to restore long-term lending in the markets. You talked about the fiscal 1983 document. The CBO estimate of the

President's budget shows different results, than your own estimates, CBO shows the deficit increasing each year, rather than decreasing, as shown in the President's documents in the 1983 budget.

People like myself, people apparently of the roundtable, people in the banking community take some of these projections with a large grain of salt, particularly when they are made by economists, most of whom did not foresee the recession that we are presently mired in. So that some of the forecasts, are not optimistic and will not be until the Budget Committee acts upon longer term realities within the budget. I think we are not going to achieve the goals we want to achieve, so I retain my very basic approach to this whole business.

The whole Federal budget has to be slowed in its growth, and by doing so, we will be able to balance it within the foreseeable future.

Mr. Chairman, I am a moderate Republican. I am not from the extremes of our party philosophically. I was thrilled to elect the President. I think he is giving great leadership to our country. But the business of this budget, and of bringing about a balance, and the leadership that Senator Riegle spoke about, that must be forthcoming from the White House, is really vital, in our opinion, my opinion as a Senator, and as a businessman.

I hope that you will take that message back to the President.

Dr. **WEIDENBAUM.** I thank you, Senator.

Senator **BOSCHWITZ.** We thank you for coming. I am sorry I missed your testimony. This meeting will stand adjourned.

[Whereupon, at 12:16 p.m., the committee was adjourned.]

PREPARED STATEMENT OF MURRAY L. WEIDENBAUM, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. Chairman and Members of the Committee:

I appreciate this opportunity to appear before your Committee to discuss the economic assumptions used in the Federal Budget for the fiscal year 1983.

My two colleagues on the Council of Economic Advisers do not have formal statements, but they also will be pleased to answer your questions.

I would like to explain briefly the economic assumptions that underlie the fiscal year 1983 Budget.These economic assumptions serve a dual purpose. They are the technical basis for estimating revenues and expenditures in future years. The assumptions also provide a picture of the economy as it responds to the President's program (see Table 1).

Table 1

Economic Assumptions for the FY 1983 Budget

(Annual averages, calendar years)

	1982	1983	1984	1985	1986	1987
Nominal GNP	8.1%	11.5%	10.2%	9.7%	9.2%	9.0%
Real Growth	0.2	5.2	5.0	4.7	4.4	4.3
GNP Deflator	7.9	6.0	5.0	4.7	4.6	4.5
CPI	7.3	6.0	4.6	4.8	4.6	4.5
Civilian Employment (millions)	100.9	103.8	106.2	108.6	110.9	113.0
Unemployment Rate	8.9	7.9	7.1	6.4	5.8	5.3

As the assumptions suggest, we are projecting that the current recession will be over by mid-year and will be followed by sustained economic growth at a rate of 4 to 5 percent a year.Simultaneously, our assumptions suggest steadily reduced inflation, down to 4-1/2 percent by 1987.

I continue to be optimistic about our prospects for economic recovery in the late spring and early summer. However, we recognize that at the moment there is a limited amount of favorable economic news. The new composite diffusion index of the National Association of Purchasing Management -- which presaged by two months the upturns in 1975 and 1980 -- turned up in December and January. Yet the Department of Commerce's leading indicators continued declining in January.

On the other hand, all indicators of price trends suggest continued improvement in the months ahead. In addition, interest rates may have resumed a downward course.

Wage settlements have also provided encouraging evidence that the economy is starting to recognize this Administration's resolve to fight inflation. Private hourly compensation, computed on a fourth quarter to fourth quarter basis, rose by 9.3 percent in 1981, down from 10.3 percent in 1980. In the fourth quarter of 1981 this seasonally adjusted index rose at an annual rate of 5.5 percent.

The need for hard and realistic bargaining on both sides of the labor-management negotiating table should be appreciated. Firms that incur unrealistically high wage bills should take into account the fact that the Federal Reserve will not ratify these decisions by fueling inflation.

Turning to projections of near-term economic activity, this quarter's output is expected to show a smaller decline than the 4.7 percent drop in the last quarter of 1981. I anticipate that signs of the upturn will become increasingly visible in the late spring and early summer. The combination of declining inflation, lower interest rates, and projected third quarter gains in personal disposable income suggest a strong growth pattern for the second half of this year. In short, there has been no change in our general outlook for 1982 since publication of the Economic Report.

For 1982 as a whole, we expect real GNP to approximately equal last year's level, with unemployment averaging 8.9 percent. This, of course, implies some increase over January's weather-affected 8.5 percent. But as I have indicated, the quarterly numbers will be showing a positive pattern later this year. The rapid growth in the economy projected for the second half of 1982 should return total employment to over 100 million. And we are projecting a decline in the unemployment rate later this year with a fourth quarter level in the vicinity of 8.4 percent.

Progress on the inflation front is encouraging and is likely to continue. The CPI rose 10.4 percent in 1981, a better than three percentage point improvement from the 13.5 percent increase in 1980. Continuation of the policy of monetary restraint provides the basis for forecasting a further slowdown in inflation to approximately 7 percent this year. The less volatile GNP deflator, which rose 9.2 percent in 1981, is assumed to increase about 8 percent in 1982.

The changes in the assumptions since last July mainly reflect the impact of the recession and the anticipated snapback from it. Thus, the current economic assumptions show much less growth in 1982 and a somewhat faster expansion in the years that follow than we previously expected. A strong recovery from recession has been characteristic of the American economy in recent decades. Indeed, the near-term growth rates in these estimates are well within the range of historical experience. Specifically, the upturn envisioned here, through December 1985, reflects an average growth rate of 4.8 percent. This compares to the composite for all past World War II recoveries of 5.1 percent.

Progress on inflation in 1981 was greater than earlier expected and that positive experience has been incorporated in our estimates. The growth of nominal GNP (real growth plus inflation) is lower than previously assumed. This reflects the maintenance of a policy of monetary restraint which will be instrumental in gradually and steadily reducing inflation.

Financing Federal Deficits

I now would like to turn to the question of the budget deficits and how they will be financed. To be blunt, the current deficit is much higher than I would like it to be but, given the recession, I believe the sensible approach is to plan carefully for reducing the deficit in the years that follow.

The relative size of the deficits is far more important than their dollar magnitude. To the extent that deficits affect the economy, the effects of a given deficit will be relatively small in a large economy and large in a small economy. In absolute size, the projected budget deficits for fiscal years 1982-1984 are very substantial. Yet, from an historical perspective, in any individual year they are not unprecedented when measured against the size of the economy, or of the budget, or of the pool of private saving that will be available to finance these deficits.

For example, as shown in Table 2, in the 1975-76 time period, the relative size of the Federal deficit was larger than we are projecting. Specifically, the deficit was 4.0 percent of GNP in fiscal 1976 compared to our current estimate of 3.2 percent in fiscal 1982 and 2.7 percent for the budget now under review, fiscal 1983. Similarly, as a percentage of private saving, the deficit represented 22.5 percent of total private saving in fiscal 1976, compared to 19.1 percent this year and 14.9 percent in 1983. Also, the deficit as a percent of total budget outlays was 13.9 percent in fiscal 1975 and 18.2 percent in FY 1976. This is in contrast to the anticipated 13.6 percent in FY 1982 and 12.1 percent in FY 1983.

Table 2

The Deficit in Perspective

Budget Deficit

Fiscal Year	Billions of $	Percent of GNP	Percent of Private Saving	Percent of Budget Outlays
1972	-23.4	2.1	12.8	10.1
1973	-14.8	1.2	7.2	6.0
1974	-4.7	.3	2.0	1.8
1975	-45.2	3.1	17.8	13.9
1976	-66.4	4.0	22.5	18.2
1977	-44.9	2.4	14.5	11.2
1978	-48.8	2.3	14.1	10.9
1979	-27.7	1.2	7.1	5.6
1980	-59.6	2.3	14.1	10.3
1981	-57.9	2.0	12.5	8.8
1982 estimate	-98.6	3.2	19.1	13.6
1983 estimate	-91.5	2.7	14.9	12.1
1984 estimate	-82.9	2.2	11.6	10.3
1985 estimate	-71.9	1.7	n.a.	8.3

In my judgment, it is very important to reduce steadily the deficit financing of the Federal Government in fiscal year 1983 and beyond, when we expect the private sector -- and its financing requirements -- to be expanding significantly. During a time of recession, such as the present, the anticipated deficit, although much larger than I would like to see, is not likely to prevent business and consumers from meeting their relatively modest funding needs. But in fiscal 1983 and beyond, when we expect a period of rapid growth in the economy, substantial reductions in the budget deficit -- and in offbudget financing -- will be very much in order.

The Reagan Administration is strongly committed to reducing the deficits in the years ahead. For a variety of economic reasons, as well as considerations of practial policymaking, deficits are a cause for continuing concern. Financing budget deficits decreases the amount of private saving and foreign capital available to the private sector, and that reduces the economy's long-term growth prospects. The effects of near-term projected deficits on business investment must, however, be viewed with full recognition of the historic incentives for capital formation provided by the Economic Recovery Tax Act of 1981. The tax policy of this Administration and the Congress represents a sharp break from the policies of the recent past. As detailed in the Economic Report, the new tax law greatly increases after-tax returns to new business investment. These incentives to new investment will, in my judgment, greatly stimulate U.S. business capital formation. Federal deficits may reduce somewhat the growth in capital formation unless there is a comparable increase in private saving, but that growth will be substantial nonetheless.

We must not forget that in order for the inflationary potential of deficits to be realized, they must be monetized by the Federal Reserve. I have every confidence that such a development simply is not in the cards. I believe that the Federal Reserve System is determined to maintain a policy of gradually reducing the growth in the supply of money.

Adherence by the Federal Reserve to its monetary growth targets will also mean a decline in nominal interest rates. Today's nominal interest rates contain a sizable inflation premium that protects lenders from a decline in the real value of their loans due to inflation. As inflation continues to decline, the inflation premium in interest rates will continue to fall. At the same time, I expect the other component of nominal interest rates -- the real interest rate -- to remain historically high. High real returns to new saving also need to be viewed in the context of the Tax Act of 1981. By reducing the taxes on the return to new business investment, business can afford to pay higher real returns to their lenders. The higher real returns available to households will, in turn, stimulate their saving, much of which will be channeled to business investment.

The bottom line of our problem - and yours - is simple. Government spending is costly regardless of how it is currently financed. That is why the first order of business is to get spending under control. The second order of business is to determine the best combination of ways to finance that spending.

All methods of paying the government's bills impose real costs on the economy -- whether it is raising funds by collecting taxes, issuing government bonds, or printing money. We have made it clear to the Federal Reserve that we are not interested in inflationary financing. Thus, in addition to our targetted spending cuts, our budget includes proposals that will result in added revenues of $34 billion over the next three years. The remainder of the spending gap will have to be financed with government securities that will be acquired by a wide variety of domestic and foreign institutions and individuals.

In short, we believe that the Administration's program represents a reasonable balance of spending, taxing, and borrowing during a difficult period of transition.

VIEWS OF OUTSIDE ECONOMISTS

FRIDAY, MARCH 5, 1982

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee convened, pursuant to notice, at 9:15 a.m., in room 6202, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Quayle, and Exon.

Staff present: Stephen Bell, staff director; Gail Fosler, chief economist; Lizabeth Tankersley, minority staff director; and Kemble Stokes, chief economist for the minority.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Chairman DOMENICI. The committee will come to order.

This is the last of seven hearings on fiscal policy and the effects of the President's fiscal year 1983 budget proposals on our economic prospects. We will have two panels this morning.

I would like to welcome the members of our first panel. Dr. Paul Craig Roberts is the William E. Simon Professor of Political Economy at the Center for Strategic & International Studies at Georgetown University. Prior to this, he served as Assistant Secretary of the Treasury for Economic Policy. Dr. John Rutledge is the president of Claremont Economics Institute, a forecasting and economics consulting firm. Finally, Dr. Sung Won Sun is senior vice president and chief economist with the Northwestern National Bank. Now, I understand that Dr. Roberts will have to leave promptly at 10:30 a.m., so we will try to move expeditiously through the testimony so that all members will have an opportunity to ask the panelists questions.

LUXURY OF INACTION CANNOT BE AFFORDED

I thank each of you for taking the time to be with us this morning to give us your views on the prospects for the economy and your recommendations on the proper course for fiscal policy. These are extremely difficult times which tend to breed confusion and inaction. But inaction is clearly not a luxury that we can affort at a time when interest rates are high and the prospect for economic recovery seems more questionable than it was just a few weeks ago. Our citizens are concerned that instead of getting Government off their backs, we have moved the Government directly into their pockets through higher interest rates and fewer jobs. I note that the unemployment rate for February was just announced and it is

8.8 percent, up 0.3 percent compared to the 8.5 percent reported last month.

I personally do not believe that we can have a sustainable economic recovery without restraining the enormous deficits we face. The President's plan is a courageous attack on those deficits, but I fear that we must go further.

I look forward to the testimony of our witnesses this morning on these issues. You are very kind to be with us and I look forward to your guidance.

I would suggest that we have a problem, in terms of conflicts today. Most committees are meeting, and wearing their authorizing hats because they are expected to send us their recommendations by next Monday. For the last 2 days, we have had Senators who have had two and three meetings at the same time. Some may have written questions. If they do, we will get them to you quickly.[1] Since we intend to start work in the very near future, I would appreciate your attempting to answer them quickly.

Why don't we start with Dr. Roberts. I hope you understand that you are welcome to give your prepared remarks. If you feel comfortable submitting them for the record and summarizing them, I will leave that up to you. Basically, we have about 1 hour and 30 minutes for the three of you, me and maybe one other Senator. So I would like to have maximum participation by the four of us. I will let you use your own good judgment in that regard, and I will not set any time.

Dr. Roberts, we welcome you.

STATEMENT OF PAUL CRAIG ROBERTS, CENTER FOR STRATEGIC & INTERNATIONAL STUDIES, GEORGETOWN UNIVERSITY

Dr. Roberts. Thank you very much, Mr. Chairman.

My remarks are only five pages, and I might be more brief if I read them.

Chairman Domenici. Fine.

Dr. Roberts. Mr. Chairman, recent headlines suggest that the economy may be in for more austerity than it can safely stand. The administration has endorsed tighter monetary targets in this recession year than last year, when the recession began.

The chairman of the Senate Finance Committee has announced that he is repealing a major part of the recently enacted business tax cut, and key business leaders and other lobbyists are urging Congress to postpone the individual tax cuts.

All of this austerity is supposed to balance the budget. It is more likely to unbalance the economy, and the budget with it.

U.S. ECONOMY STRUNG OUT ON CREDIT

The simple fact of the U.S. economy is that it is strung out on credit. This is the fault of the tax system, which has damaged the cash flow of individuals and businesses. With taxflation—a combination of high marginal tax rates and inflation—taking most of the gains in individual incomes, people have been resorting to debt to finance their gains and consumption. Since the interest on their debt is tax deductible, being in debt was the only way to get some of their income back from the Government and experience a rise in living standards.

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[1] See p. 645.

Indeed, the only way most people could save at all was to go in debt and rely on taxflation to push up the value of their homes and appreciate the value of their mortgages.

Businesses were equally encouraged by the tax system into becoming "debt junkies." Their depreciation allowances were stolen by taxflation, severely reducing their cash flow, and curtailing internal financing. Since payments to equity must be made from taxable income, but debt service is tax deductible, businesses became increasingly debt dependent.

Simultaneously, the Fed was trying to keep interest rates down by making more money available. As money growth rose, so did the inflation rate, which pulled up the interest rate. Eventually, people's expectations of inflation rose faster than inflation itself, leading to greater demands for credit.

IMPROVE CASH FLOW

The only way out of this kind of dilemma is to improve the cash flow of individuals and businesses, while gradually reducing the rate of money growth. That was the plan of the Reagan administration. The business tax cuts produce a dollar-for-dollar increase in business cash flow. Even firms with no profits had, until Senator Dole's announcement, an alternative to borrowing. In the leasing provision of the tax bill, they could sell the unused depreciation allowances and tax credits.

The individual income tax deduction raises people's cash flow on the existing income levels and also allows them to obtain a larger percentage of their income gains. The combination makes it possible for people to pay down their debt while still experiencing a rise in consumption.

Whether you look at it from a Keynesian or a supply-side perspective, the approach obviously makes more sense than one than requires people to pay down their debts by reducing their consumption.

The monetarist leg of the administration's plan was for the Fed to peg the quantity of money rather than the interest rate. By gradually reducing the quantity of money, the Fed could wean the economy from excessive credit, without precipitating a recession. The Reagan plan was to reduce the rate of money growth by 50 percent over a 4- to 6-year period. What the Fed delivered was 80 percent of this reduction in money growth in the first year, an extraordinary recessionary policy. In addition, the Fed has failed to keep to a steady, predictable course. Money growth has been increasingly volatile, with Fed policy consisting of return trips between too loose and too tight.

It is beside the point for the Fed to argue that U.S. monetary policy is less volatile than some other countries, and that when averaged over the year, money growth is reasonable.

UNCERTAINTY ADDS TO INTEREST RATES

The relevant points are, first, U.S. monetary policy is more volatile than previously, so for U.S. financial markets, there is a rise in uncertainty; second, people live and operate in discrete units of time, not in an average year, and a monetary policy that alternates between taking out too much money and putting in too much money is a policy of uncertainty. Uncertainty adds its premium to interest rates.

In view of the failure of monetary policy, regardless of whether the fault lies with the monetarist policy or with its implementation by the Fed, it is difficult to understand why the administration has closed ranks behind the Fed and instead focused attention on the President's budget policy as the source of our economic problems. People are mistakenly blaming the tax cuts for the deficit, and the deficit for the failure of monetary policy to lower interest rates.

The view is taking shape that we must raise taxes on businesses and individuals in order to reduce Federal credit demand, so that the Fed can lower interest rates. But higher taxes reduce the cash flow and income gain to the private sector, thereby raising credit demands and heightening illiquidity. In a year's time, policy has moved from one of economic growth to one of austerity. Congress seems to be giving no thought to how a policy of tighter money targets, combined with repeal and postponement of business and individual tax cuts, is going to get the economy out of the recession.

In thinking about where to go from here, keep in mind the real mistakes of last year. A year ago, when the Reagan administration announced its program, critics responded that the tax cuts were going to send the economy up in the smoke of inflation. These critics succeeded in frightening the Fed, the Congress, and members of the administration. As a result, the Fed, fearing an inflationary fiscal policy, overcompensated on the monetary side, holding monetary growth flat for half of the year. On the fiscal side, the administration and the Congress, in an attempt to keep tax revenues high and balance the budget, delayed and scaled back the personal tax cuts. Instead of the 20-percent tax reduction that was intended by January of this year, it was 5 percent, and it was overtaken by bracket creep. Consequently, there was a deflationary monetary policy and no tax cut, which guaranteed a recession and large budget deficits.

If the Government now responds to the budget deficits with more of the same policies that produced them, the economy could be pushed from a recession to a depression.

Mr. Chairman, the economy is in a recession. Large deficits are the normal accompaniment of recession, and all recoveries take place in the face of budget deficits. If you focus on the deficit as cause rather than effect, and you direct policy toward reducing the deficit rather than recovering from recession, you risk worsening or prolonging the recession, in which case you would defeat your purpose of reducing the deficit.

A recession is a time when demand and cash flow are falling. If you adopt tax and expenditure policies that further restrict demand and cash flow, you may simply worsen the deficit by worsening the economy.

TURN ATTENTION TO MONETARY POLICY

A recession is a dangerous time to try to lower interest rates by balancing the budget. You would be more likely to succeed in lowering interest rates without collapsing the economy if you turned your attention from fiscal policy to monetary policy. No one is going to believe that tax cuts cause recession, or that tax cuts cause erratic and uncertain monetary policy, or that the proper treatment for the lack of economic growth is austerity and higher taxes. Unless we discover and reestablish the conditions for monetary stability, no fiscal policy can succeed.

Chairman DOMENICI. That was a quick five pages. Thank you very much.

WHERE WAS POLICY ENUNCIATED

I just have one question, before I go to the next witness. Early in your statement, you spoke of the original Reagan plan—maybe that is the wrong word—and you spoke of a 50-percent reduction in the money growth over a period of time and said that is not what happened. I agree that is not what happened, but I would like to know where that policy was enunciated, the 50-percent reduction in the growth of money supply over a period of time.

The reason I ask is I heard early on everyone in this administration—not you—saying that the Fed was doing right, and they were not on a 50-percent reduction plan.

Dr. ROBERTS. I do not think the administration knew what the Fed was doing. There were the monetarists in the administration, Mr. Chairman, who were very much concerned that the Fed was going to accelerate money growth, and therefore, any development in the opposite direction was sort of encouraged. But the policy that I described was often heard in the Treasury and within the policy discussions in the administration. To pinpoint to you some particular document it is written in, I would have to go and do some sort of research in my files.

Chairman DOMENICI. No, no, I did not mean that.

Dr. ROBERTS. But I have never heard any other policy either from Beryl Sprinkle, the Under Secretary and my former colleague, or any discussions about assumptions on monetary targets when we were trying to produce the forecasts and outlooks.

You see, Mr. Chairman, the monetarists were convinced that unless the money growth came down very gradually, it would produce a recession, and they were worried that if it came down too quickly and produced a recession, that the response would be a great outpouring of money and that we would be back on the same, stop-go cycle, and they were very concerned that we get off that cycle. That is why they wanted that money growth to come down very gradually.

Chairman DOMENICI. Well, the reason I asked about the policy, and I did so, actually, Dr. Roberts, in total good faith, because I have not heard it enunciated publicly. The chief monetary policymaker in Treasury appeared here about 3 months ago, and he was not saying that the Fed was doing anything inconsistent with the policy, and that was not a 50-percent, easy-as-you-go policy.

So, I mean, you are telling me something——

Dr. ROBERTS. That is all I have ever heard him say, Mr. Chairman.

Chairman DOMENICI. We have the record of when he was here. In fact, I think he said that he thought the Fed was doing precisely what the administration's policy required. I would be glad to show that to you. I mean right here, in front of us——

Dr. ROBERTS. Is that very recent? You are speaking of the Under Secretary?

Chairman DOMENICI. Three months, yes.

Dr. ROBERTS. Well, you know, recently, there has been the accord, that I criticized in my statement, that somehow, the administration would get behind the Fed and stop the criticism. So he could simply be behaving in accordance with the accord.

Chairman DOMENICI. Well, this was before the knowledge of the end-of-the-year aberration, from tight to rather loose, the large jump. It was just before anybody knew that. He was here, saying they are doing just about right, and very, very tough on anybody saying, "Loosen up supply; it is too tight." So I do not think any of us would have known about the 50 percent, or gradual-as-you-go, and I am not questioning what you have told us here, that, sitting around, that is the way it evolved, and you always heard it that way. I am just saying we never did.

Dr. ROBERTS. Well, you should have had me down to testify, Mr. Chairman.

Chairman DOMENICI. All right.

We want to hear now from Dr. Rutledge, the president of Claremont Economics Institute.

Doctor, please proceed.

STATEMENT OF JOHN RUTLEDGE, PRESIDENT, CLAREMONT ECONOMICS INSTITUTE

Dr. RUTLEDGE. Thank you. I will also summarize my remarks, and put the text into the record, if I may.

I would like to address, really, only a few points in this discussion this morning. Some of the points, I have charted on the wall, and there is also a packet of charts, which I hope you have in your hand, containing some of the ideas.[1]

Chairman DOMENICI. Yes, sir.

Dr. RUTLEDGE. Some of these points are simple-minded ideas, and that is partly why I have so much confidence in them. Let me move forward on that.

The main issue here, I think, is whether the economy can recover, what the role of monetary and fiscal policy is in allowing that to happen. It seems to me, both from what I read and also from what I have observed in the last year, that there is a great desire to recapitalize the economy and bring about new capital formation.

PROTECT CAPITAL STOCK

I put the whole hopes for the recovery, long term, on the ability to generate new capital in the economy. It is very easy to see why. In fact, that is really my alternative to these various subcults of economics. There are all sorts of civil wars going on now among monetarists and supply siders and Keynesians—you pick your name, and you can be on one side or the other. What has occurred to me is that it is not very productive to have those fights, and instead, I would like to formally identify all of us as capitalists, and that is really the thing that binds us all together. By "capitalists," I mean that we all make our living off the capital stock. The capital stock is all of the machines and the factories we have, it is the technologies that have been developed, it is the R. & D. budgets of the corporations, it is the training of the workers. That is the thing, as I travel around, that makes people in this country rich, relative to people all over the world. I was last year in 40 different countries, and I saw some real poor people. They work hard like we do, they are smart, just like we are, but they do not have any machines and they do not have many resources. So, protecting that capital stock ought to be the first priority in budget policy. Making it grow is the necessary ingredient to getting the economy going again. That is where I start this discussion.

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[1] See p. 403.

CAPITAL FORMATION

Now, about capital formation, as I said, my ideas on this subject are very simple. They are not drawn from economics journals, although I have read a few of those. They are really drawn from a series of meetings. In the last 7 years, I have been involved advising various corporations on their investment policy. I have worked with more than 150 of the large corporations in that time, and I have seen about 30 of them this week. My view on how they make investments is really that first chart in your packet of handouts.[1] It is a balance sheet, and it has only one item on each side. For the economy as a whole, the assets of the economy boil down to this capital stock I talk about. But there is a balance sheet relation tying the economy together that every dollar of capital has to be offset with a dollar worth of financial assets in the markets. It happens this way. I have sat in on a hundred of these meetings in the last 3 years. Every investment committee has three people in it. There is a chief executive, a chief financial officer, and a chief planning officer.

The meeting goes like this. The chief planner brings in a great stack of paper, plans for a new ethylene plant or a new aluminum smelter or something. The boss says, "Well, how much money does the thing make?" and he said, "Well, for about the first 5 or 10 years, it will actually cost us money. We will have to build it and fund it, and then it will begin to spit out money over about a 70-year time horizon." The boss then turns to the chief financial officer and says, "Where are we going to get the money?"

Well, where are we going to get the money and how much investment we do are exactly equal decisions. They are exactly matching transactions in the market. You cannot build a factory without financial markets. The sum of the health of the bond money, equity and retained earnings markets is the resources available for capital formation.

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[1] See p. 403.

DECISIONS IN 1900 COMPARED TO TODAYS

Let us look at those kinds of decisions in 1900 and compare them against the ones we are doing right now.

In 1900, the planner or the engineer brought in plans for a new factory, and it said, yes, we will produce widgets for the next 50 years, and these are the cash flows necessary to produce that widget factory. He turns to the financial officer and says, "Where are we going to get the money?"

"No problem. I can get you 50-, 60-, 70-year bond financing for that." That financing matches on cash flows against the outflows to produce the project, and what that implies pretty much is that the boss is not in danger of getting fired during the next 10 years.

I would urge you to discard whatever mathematical formulas that people use to estimate investment spending, because every, single investment decision is made by a human being. That human being is the chief executive of that business, and he will not make it if he cannot be assured, in some sense or another, that it is not going to blow up in his face.

The investment decision now is quite different than it was in 1900. The same three guys are there. The engineers still only know how to make 50- or 60-year factories, but the treasurer only knows how to provide 6-month financing. So when you compare the cash flows on paper, what he sees is 6 months' worth of known cash flow costs, 50, 60 years worth of commitment on the investment side. I do not know the single chief executive of any of the companies I advise who will build a factory on that condition.

So the problem we are talking about here is not lack of money. Those guys can get money. The companies I was working with this week can go out and borrow short-term money all they want. It is not even the cost of money, because if they could find the right investment project, they could justify a given cost of money. It is the lack of long-term financing at a fixed price which is doing that.

MATURITY STRUCTURE VERY IMPORTANT

So this balance sheet needs to be kept in the back of our minds when we are thinking about investment spending, because if you want to stimulate capital formation investment spending, the key to doing that is providing those three people in that meeting with financing which lasts as long as the capital projects they want to implement.

So the maturity structure is very important. But that simple balance sheet is not just true in dollar amounts; it is also true in terms of its maturity structure, because in the old days, we had long-term factories and equipment, long-term financing, minimal cash flow or insolvency risk; that encouraged both investment and maintenance of plant and equipment.

Now what we have had across the whole economy is a shortening of the horizons in the financial markets, so that that balance sheet across the economy now is mismatched or unbalanced.

The problem is very familiar to people regarding savings and loans. They all know that the savings and loan association is a place that has 30-year assets, funded with 6-month deposits, and they have got a problem. Their problem is every time interest rates jump, they have a cash flow squeeze. Well, look across the whole economy, and ask yourself if United States Steel is in any different shape than that savings and loan, or Chrysler, or the chemical industry, or any of these people.

The problem is that all of them have short-term financing available to fund a long-term capital. It is an extremely risky balance sheet to ride if you are the chief executive.

So what do you do? The savings and loan, faced with this kind of an environment, decides not to make any new mortgages. They decide to let the ones they have run off. Well, that same decision for somebody running a steel mill is to not build a new steel mill and to allow the one you have to wear out. So on capital grounds, when you are faced with financial markets which will only make commitments a short way ahead, that puts an effective constraint on the ability of anyone to make investment, with or without any current cash flow.

MAKE FIXED PRICE MONEY AVAILABLE

The upshot of that discussion is that nobody who runs a real corporation is going to make a serious, long-term commitment based on this year's cash flow, based on 2 years' cash flow, or based on 3 years' cash flow. They have got to have fixed price money available to them for 20, 30, 40 years. They need a bond market. And the demise of investment spending and savings, analyzed from this perspective, needs to give a lot of weight to what is going on, on the financial side.

Now, why aren't people willing to make commitments in the financial markets? It is really pretty simple there. Between 1780 and 1930, the price level did not move at all, except during wartime. That is, people had 150 years' worth of stable prices to look at, so they did not get their money taken away from them every time they made a financial commitment.

Since World War II, the price level goes nowhere but up, so that anyone who loans out money at any fixed rate over a long period of time has lost money during that period. They learn those lessons. That makes them shorten up their commitments, just like you would drive more slowly in the fog. That unbalances the economy's balance sheet. That mismatching forces either of two things to happen. If the financial markets will not make long commitments—that is, if people cannot believe in the price level—then the capital stock is going to wear out, and it will become short-term capital. That is the British disease. I have seen it in 10 different countries last year. Go to Buenos Aires, go to Algiers, go to any of the countries that have had long periods of inflation and a budget policy that people cannot count on. That is what happens to any economy.

Now, this is a big country, and like people say about companies, it takes a lot of killing. But we are already starting on that. I think we are already in stage two of that cancer process right now.

How many companies do you know that are selling for their own replacement cost? I do not know any. If the company is selling in the market below its replacement cost, and it is paying dividends at the same time, that says the management is explicitly deciding to destroy the capital of that company and give it back to the shareholders so they can put it in a money market fund where they do not have to make commitments anymore.

That is the process going on, and I think it is a very dangerous process. So, recovering the capital market, recovering investment spending, and getting the economy moving again requires the financial markets to heal. It cannot be done with current cash flows. So, the notion that you can just give people current cash and make them make investments is wrong. It is not wrong because of an equation. It is wrong because the 150 chief executives that I work for just will not do it. They cannot bear that amount of risk.

Item No. 1 is on investment spending.

DEFICITS IN TAX POLICY

I would like now to move forward to another topic which I think is just about as simple as that one, which is the role of deficits in tax policy.

There is a notion that says that you can somehow change tax policy without changing spending, which just baffles me. The second sheet of this handout, on this handwritten page lays out another one of these identities. The reason that I like identities in balance sheets is that you can count on them if things get tough.

Well, the left-hand column of that thing is an identity. What it says is, after you set the amount of Government outlays that have to be paid for, the amount of tax collection is fixed. There can be no variation in tax collection after you know how big Government spending is. So that item, that you ought to view spending as the size of the tax burden, is an old piece of conservative economics, way back to Milton Friedman. Everything you ever say, Milton said it 25 years ago, and this is one of them.

If you add up, essentially what happens is you present the bills to the Treasury Department; you pay whatever you have got out of current tax receipts. If you do not have enough, you have to borrow the rest. If the Fed buys some of that, then essentially, you are printing the revenues to do that. So that there are really these three very basic categories of tax expenditures or tax collection that the Treasury can do.

But, just like any other taxes, each of those three taxes has very different effects on the economy. They are not all the same, by any means. It is first of all incorrect to refer to the first one as taxes and the other two as nothing, as if they have no burden at all on anybody, and they do not impede any sort of economic activity. In fact, I like a lot of the incentive-based discussions in the supply-side literature, but what I would like to do is apply those same points to those second two kinds of tax, and see what we get out of it.

Well, in a year like last year, in round numbers, to pay about $660 billion worth of bills, about $600 billion of it came through taxes, about $50 billion of it through borrowing, and about $10 billion of it through printing, in round numbers.

CONGRESS CONTROLS TAX RECEIPTS PRETTY CAREFULLY

What are those taxes like? Well, in terms of who controls the taxes, Congress controls tax receipts pretty carefully. That is, you can structure the Tax Code to do more or less—subject to H. & R. Block—what you want to do. Borrowing is virtually uncontrolled, as far as who pays it, because the policy is not in the hands of Congress. Printing is entirely uncontrolled. It is an entirely unlegislated form of taxes. Who pays it just depends on the luck of who happens to be holding dollars or financial securities.

In terms of flexibility, current tax receipts are a very inflexible form of collecting revenues. Money printing and borrowing are much more flexible ones, so they get an advantage there; they can act as a shock absorber. But the real important point of tax policy, I think, is to talk about the incidence of these three forms of taxation, for whereas current tax receipts are paid very broadly across the economy by both savers, investors, and consumers, based on income production generally, borrowing is really an excise tax, which is paid by security holders. Now, the way that works is the security markets are a place where there is a big pile of paper that always has to be owned by somebody. The prices of those pieces of paper will be determined by how big the pile is and by how badly people want those assets. If the Treasury comes to the market with new borrowings and makes the pile of paper bigger, so that in order to accommodate this new issue of paper, all of the previously owned assets must decline in market value. The decline in market value of the secondary market for securities across the country measures the excise tax imposed on the securities markets from Treasury borrowing. All that says is that Treasury borrowing makes the interest rates go up a little bit. That implies that bond prices, stock prices, and other asset prices go down some. The degree to which they go down is an excise tax. It is not all dead weight loss, because it also transfers some wealth to people who were smart enough to borrow money last year, because you can sell your 4-percent mortgage now for more money in a 6-percent mortgage environment.

EXCISE TAX NATURE OF BORROWING

Well, that excise tax nature of borrowing and printing both really has not been talked about too much. What it really implies, like any other excise tax, if you tax a certain activity, less of it happens. Well, what does this imply about this excise tax with borrowing? It suggests that you are taxing only the owners of securities. That means people are going to be less eager to own securities than they were before. There is a transfer toward people who had issued securities, so people are going to be more eager to borrow money than before. And by continually taxing people over a period of years for owning securities you end up drying up both the size and the maturity structure of the stock of financial assets in the economy. Back to my first discussion, that implies that those three guys sitting around that table are not going to have any bond money available to them when they come to the market and want to build a new factory. So the financial side and this excise tax nature of borrowing is very important.

You might ask, why is the balanced budget—you know, good, conservative dogma has always said that you have got to balance the budget. I have been skeptical about that as a proclamation for years, because nobody ever explained why.

I have had a piece in the Wall Street Journal in December that suggests that even a $100 billion deficit is not an awful lot of money relative to the amount of assets that people own, and that in a given year like 1982, when there is a tremendous dropoff in inflation just happening for other reasons—OPEC and the Fed—that is making people lose money on all sorts of real assets, so that financial assets start to look pretty good. And to the extent that people are encouraged to go in there and buy financial assets it can offset some of that Treasury borrowing. In fact, during 1982, even with a $100, $125 billion deficit, our forecast is that interest rates are going to decline during the year. So the deficit is not a bogeyman; that is the first point.

ALWAYS WANTED BALANCED BUDGETS

The second point is why has everyone always wanted to have balanced budgets. I mean, that is locked in to the American idea. I think it is pretty simple. Balanced budget policy was really first put together by Alexander Hamilton, now a famous dead man—you know, when you are a dead lobbyist or an economist, you become a scholar, and Alexander Hamilton is now one of those—well, he said, as reported by Andrew Mellon, that—

> It will be the truest policy of the United States to diminsh present debts, prevent the accumulation of new debts, and secure the discharge within a reasonable period of any as it may be necessary to contract.

In other words, the Government could only borrow money to finance war, and then they had to pay it back. Now, the idea you have to pay the debt back seems pretty novel, since functional finance and all that, but we ran the country that way for 150 years, at least up until the middle of the 1920's. Andrew Mellon, who is often cited as a supply-sider because he engineered a reduction in tax rates in the middle of the 1920's, said after that—

> Throughout its history, the U.S. has followed the policy laid down by Hamilton of funding the debt so that it can be liquidated without undue hardship. At the same time, the policy has been strictly adhered to that expenditures for the ordinary operations of the government must be discharged out of current receipts raised from taxes.

must be discharged, year by year, out of current tax receipts.

Now, ordinary operations of the Government, to Mellon and to everyone up until World War II, included an ammortized payment on the debt, so that in fact, between 1919 and 1923, when those tax rates were lowered, Mellon succeeded in paying down the national debt by more than a quarter. In the 1923 budget, 11 percent of the budget was earmarked for debt repayment. So there was a massive surplus.

RETIRE DEBT BY PAYING MONEY BACK

Mellon went on to argue—we can see it later in the written testimony—that it is in fact beneficial to retire the debt by paying the money back, because orderly debt retirement out of surplus revenue is likely to restore prosperity by giving the money back to the people who make investments with it.

So this guy by no means at all was a guy who thought you ought to borrow your way along and pay bills that way.

Now, if that is true, and if that balanced budget notion has been part of dogma for such a long time, what is the sense of it? Well, I think the sense of it is in the last few columns of that table we just talked about. It says that borrowing is a tax that only impinges on capital formation; it does not cut at all against consumption. And if you want to grow more machines and factories, it is a really dumb way to collect the money, to take it out of the capital. Take it out of the market where people are spending it, instead. That is one.

But there is a second one which is, I think, even more important. Adam Smith, another famous dead economist, a long, long time ago, laid down his rules for how you ought to collect taxes. The fourth one of them is called the efficiency maxim and it says that taxes ought to be collected in such a way as to take the least out of people's pockets as possible in order to pay the Treasury's bills, basically, which is nothing more than the idea that if you are carrying water from the creek to the cabin, you should not use the bucket with the hole in the bottom. The cost of the tax policy and the amount of money the Treasury get do not at all have to be the same thing.

As a very, very homely example, if I were the Treasury Secretary and I wanted to collect $1.80 in taxes, one very practical way to get it would be to take any one of the people in this room, grind you up, and sell you to one of the chemical companies for your component elements. You would get about $1.80 out of that. But basically, most of the people I know would pay $5, $6 to not have that happen to them—implying that the tax burden and the amount of money the Treasury gets do not have to be the same at all. Efficient tax policy picks the cheapest source of tax revenues.

COST OF COLLECTING TAXES

How much does it cost to collect taxes? If you collect them through current receipts, you have to pay the IRS to come and take your money. Our best guess is that to get $1 to the Treasury through current taxes costs people about $1.01. In other words, that source of tax revenue is about 99 percent efficient; a pretty efficient form of collecting taxes. To get $1 to the Treasury by borrowing the money, in our estimate, suggests that you have got to destroy between $5 and $10 worth of securities to do it. Not all that is loss to everybody. Some of it is a transfer to borrowers. But nevertheless, it has these incentive effects we talked about.

You have got a tax which is 99 percent efficient, and you have got one which is about 10 percent efficient. That, in and of itself, is a pretty good reason why, over long periods of time, these guys made sure you collected the revenues for the expenditures of the Government out of current tax receipts and not borrowing, using borrowing as a shock absorber instead.

Printing is the most expensive kind of taxes. To get $1 to the Treasury through printing, you have to increase the monetary base by $1. That increases M_1 by $2.50. It pushes the price level up in proportion to that, and raises interest rates enough to destroy about $100 worth of security values in the markets—the bond, money, and equity markers.

The only other one of those pictures on the wall that I want to point out is also in this packet—well, really, two of them.[1] If I could point at that for a second, then I will be done.

You have got two different measures of tax collection. One of them is just how much taxes we pay. Now, this is average rates, not marginal rates.

Federal tax receipts as a percent of GNP since 1960, and what I see for that line is they go up and down a lot, every time there is a boom and bust in the economy, which is this endogenous nature of the budget. In 1960, we paid about 19 cents on the dollar to the Government, and last year, we paid about 21 cents on the dollar. It is hard to get awfully excited about that 2-percent increase over 21 years, as far as the burden, as far as the costs on people. There certainly are incentive effects involved.

It is hard to explain why that also generates a revolution to me. The local State phenomenon is probably more likely to do that, because if you had those in, the numbers went from 28 to 35 percent.

What I would do now is——

Chairman DOMENICI. Dr. Rutledge, I am glad you only have about 3 minutes more, because you and Dr. Roberts have had a field day here.

Dr. RUTLEDGE. No; we will have a good discussion—in true Virginia principles, right?

Dr. ROBERTS. He is going to talk, while I have to leave.

Dr. RUTLEDGE. Yes; that is a strategy I learned a long time ago. This is a picture which I think measures the problems in the last 20 years. It is another way of thinking about tax policy. What it says is if you take these three kinds of tax collections, and you add on how much they cost people, this bottom line is Federal, State, and local tax payments by individuals to all governments in the last 21 years. In 1960, it was 21 percent, last year it was 35 percent. It went up. That is enough to make me mad. It is probably enough to hurt productivity some, but it is not enough to destroy the Western way of life.

This line is what we get by adding to those tax collections the amount of security values that were destroyed by excise taxes imposed on the markets through borrowing and printing activities. That total in the early 1960's was not much different than tax collections, implying that the Treasury did not collect much money through borrowing and printing. In fact, in the early sixties, they stopped borrowing and printing to the extent that there was actually a tax rebate back into the securities markets. There was a boom in the bond and money markets and the stock market. That boom is a rebate, which takes the form of this little region here. It was just before the 1964–65, and so forth, tax cuts, and is an alternative explanation for why you got so much capital formation.

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[1] See pp. 405 and 406.

STIMULATE FINANCIAL MARKETS

In other words, this says that the tax burden is the problem in getting capital formation. But let us take a very broad view of what taxes are. And if you want to get rid of them like we did in the 1960's, stimulated financial markets may be the way to do it. The war on poverty and the Vietnam war show up here as enormous increases in these excise taxes, over and above what the Government told us they were taking out of our pockets. So this is essentially the unlegislated component of tax burden on the people. And that got up to in a region between 60 and 80 percent of gross national product.

Now, what does that imply? Sixty to eighty percent of GNP probably implies that the capital stock growing and starting to decay over that time. So I would expect to see falling productivity, falling real wages, falling standards of living across the country and people starting to get mad.

Well, that seems to be the 1970's. We have now pushed up the borrowing and printing activities to the point where, last year, that $660 billion—the $600 billion that was taxed cost people about $606 billion. The $50 billion that was borrowed cost people about $500 billion. The $10 billion that was printed cost people about another $1,000 billion, or $1 trillion.

NOT VERY SMART TAX POLICY

So, in order to get the Government $660 billion, we were able to pay $2 trillion to do it. Now, that is not a very smart tax policy. It is that, just a tax policy. It is how you get the money; it is not how much you get, because the Treasury only got to spend $660 billion. What that suggests is if you lower tax receipts without lowering spending, you are in fact increasing the tax mode, which must be paid by people, not only the volume and size of it, but also, the incidence of it falls more and more on capital formation.

This suggests that taxes are the problem, but in order to get them down, you have got to be much more aggressive on the spending side. If you cannot, for some political reason or other, get spending down ever, then the Hamiltonian idea about how to finance the budget over the long term has still got to be the right one. Borrowing is very flexible. It is the shock absorber to use when you cannot adjust tax receipts on a day-by-day basis to Government outlays, but it does not make sense to use that as the long-term policy to finance the budget.

Now, that explanation was really cooked up this fall as I was doing work for the governments of Argentina and Brazil. I was able to calculate those things down there for those people. But what I would suggest is there is at least some danger that we are on the same path. We may be in the first inning, they in the seventh inning, but nevertheless, those are the kinds of problems we have got to grapple with.

Thank you.

Chairman DOMENICI. Thank you very much.

PREPARED STATEMENT OF JOHN RUTLEDGE, PRESIDENT, CLAREMONT ECONOMICS INSTITUTE

1. INTRODUCTION

The Federal deficit is probably the most discussed and least understood topic in economics. To some it is the source of all evil; others claim that deficits don't matter at all. Both views, of course, are incorrect. The deficit is not a bogeyman; neither is its influence benign. Its effects on the economy must be analyzed in the context of an analytical framework which is capable of incorporating the influence of deficits on interest rates, capital formation, and ultimately on economic activity. I believe that a simple capitalist framework, like the one outlined below, focusing on the relation between capital accumulation and the financial markets, provides the most useful way to make sense out of the confusion of arguments over how to manage the Federal budget which fill the press today.

2. INVESTMENT, ECONOMIC RECOVERY, AND THE FINANCIAL MARKETS

The recovery of business fixed investment plays a central role in the Reagan Administration's plans for economic recovery. Most economists recognize that it would be extremely unlikely for the economy as a whole to recover from recession without strong performance from the capital goods sector. More importantly, the Reagan program recognizes the desirability of changing the mix of goods produced in the economy away from the consumer goods and toward capital goods, since the stock of capital goods represents the tools for future production. Hopes for increased productivity and rising standards of living all depend on steady growth in the quantity and quality of the nation's capital stock.

Unfortunately, while the need for the capital formation called for in the Reagan program is widely recognized, the means by which increased capital formation is supposed to be generated are not well understood. Despite claims to the contrary, tax cuts alone cannot bring about a turnaround in investment spending. As the following analysis suggests, sustained increases in business fixed investment can only come about as a result of improved health in the nation's financial markets. Healthy financial markets, in turn, can only come about as a result of policies which succeed in restoring investors' confidence in the soundness and integrity of long-term financial assets.

When thinking about investment spending I find it useful to discard all of the mathematical expressions for desired capital stocks, cost of capital, and so forth that fill the economics journals, and to focus instead upon the following very simple balance sheet relation for the economy.

Figure 1

Simplified Balance Sheet for the Economy

A	L
CAPITAL STOCK	FINANCIAL MARKETS

The simple fact pointed out in Figure 1 is known to anyone who has ever made an investment decision. Every decision to accumulate capital, whether through investment in plant and equipment, increased inventories, improved education and training of the workforce, or R&D expenditures on developing new technologies, involves a matching financing activity. Every dollar of new capital put in place must be raised in the financial markets through issues of equity, bonds, or money market instruments, or through retained earnings. In a very real sense, then, the size and quality of a nation's capital stock is constrained by the health of that nation's financial markets. As a simple matter of arithmetic, if there is no financing, there can be no investment. Financing, in turn, depends on the willingness of the public to hold financial assets. If investors will not buy corporate securities, there can be no investment.

As I mentioned above, this simple investment theory is not the result of manipulating mathematical expressions; rather, it is the result of observing the real world. In the past seven years, I have personally participated as an advisor in the investment decisions of over 150 corporations in the U.S. and abroad. Formally, investment committees are all rather similar, comprised of the chief planner, who evaluates the probable cash flows of the proposed investment prospect, the chief financial officer, who worries about where the money is going to come from, and the chief executive, who gets the blame if the whole thing goes wrong. The format of the meeting is usually for the chief planning officer to present to the CEO a detailed analysis of the costs and revenues associated with a possible capital expansion, say an expansion of furnace capacity in the steel industry, over the life of the proposed project. The CEO then turns to his chief financial officer to ask for a report on the financing options open to the corporation, and what sort of cash outflows can be expected to cover the project until it will pay its own way. This is where the trouble starts.

In the early 1900s, the extremely healthy long-term debt market meant that the CFO was able to provide financing of maturity comparable to that of the physical investment. This meant that the CEO could look at relatively certain financing costs over the whole life of a project. He could focus his attention on the underlying business problem; that is, whether or not people are going to want to buy steel over the next 60 years, and if so, whether or not we will have access to the resources to produce it. These are the gambles that CEOs are paid to take.

Today, these meetings look much the same, but the decisions are going the other way. The problem is that capital investments take just as long to build and, once built, they last just as long as they did in 1900. That is, industrial engineers have not yet found a way to build disposable factories. This means that the planning officer is still bringing fifty, sixty, and seventy year projects to the investment committee. Unfortunately, the CFO can no longer provide fifty, sixty, or seventy year financing at known costs for these projects. Instead, the CEOs who run our corporations are being asked to make fifty-year capital commitments with six months' commercial paper financing, or with rollover priced bank credits. To do so would be insane, sending the company into insolvency the first time short-term interest rates skyrocketed during a refinancing period.

Faced with short-term financing for long-term capital projects, most CEOs decide that the proposed investment is too risky, and the project is either cancelled or delayed until more favorable financing is available. The result in recent years has been a declining share of investment as a share of GNP, an aging capital stock, reduced productivity and a worsening international competitive position.

In this view, the investment problem is not caused by high borrowing costs, although they certainly worsen the problem; nor is it due to lack of money, for corporations could certainly borrow the money to do the projects. Rather, the problem is lack of long-term money at fixed interest rates, i.e., the demise of the bond market. This suggests that a capital recovery cannot be force-fed to the economy through changes in the tax laws which give increased current operating cash. A sustained recovery in capital spending will not happen until adequate long-term financing is available, i.e., until people are again willing to own long-term financial assets.

In terms of the balance sheet in figure 1, this suggests an implied relationship between the maturity structures of the physical assets (capital stock) and the financial assets that make up the economy's balance sheet. In the early 1900s, the previous 150 year record of stable U.S. peacetime price levels encouraged financial investors to make long-term commitments. The railroads, for example, sold one-hundred year bonds to finance track expansion at interest rates of below 3%. The long maturities available in the financial market allowed corporations to move forward with major investment projects at acceptable levels of risk.

Since 1960, however, conditions have changed. The record of stable prices has been replaced with continual inflation. Rising interest rates that have accompanied rising inflation have destroyed large sums of capital in the bond and equity markets, and shortened the horizon (as well as increased the price) over which investors are willing to commit their funds. The result has been a shortening of the outstanding maturities of securities in the financial markets as investors attempted to protect their capital.

Unfortunately, the shortening of maturities on the financial market side of the economy's balance sheet has left the economy in an unbalanced, or "mismatched" position, since the maturity structure of the capital stock has not been able to shrink in parallel. This means that all across the economy, companies are faced with long-term capital assets, and short-term funding. This is an untenable position for the economy as a whole, just as it is for any single company. Faced with long-term capital and short-term financing, companies across the country are unable to justify new investments and continued expenditures on R&D. In fact, faced with equity values far below replacement costs, many companies are unable to justify maintaining their current capital in working order. Instead, they pay their capital out to investors through dividends they can't afford. The result is an aging and shrinking stock of useful capital.

This analysis suggests that a seriously mismatched balance sheet cannot be sustained over the long term; left to itself it will lead to reduced capital outlays, which will eventually shorten the useful life of the capital stock. This condition generates an economy which is essentially marching backward in time, producing falling productivity and reduced standards of living. This is the situation in which a great many highly inflationary economies around the world find themselves today. The United States is in the early stages of this cancerous process. It is a mistake to think that this process can be reversed through tax policy alone, without addressing the underlying balance sheet problem, confidence in the long run purchasing power of the money.

3. DEFICITS AND TAX POLICY

The mistaken belief on the part of many analysts that tax concessions alone can lead to sustained increases in the capital outlays can be traced, I believe, to a fundamental misunderstanding of government finance. Many economists talk about tax policy as if it were something entirely independent of spending policy, and treat explicit taxes as something quite different from government borrowing (the deficit) and money printing. In fact, they are not different. The Treasury Department's budget must balance every minute of every day, just like yours and mine. If the Treasury fails to collect enough tax revenue to pay the government's bills in a given period, then they must collect the remaining "taxes" by some combination of borrowing and printing. All three, taxes, borrowing, and printing should be interpreted as alternative sources of tax revenues, each with its own patterns of incidence, incentive effects, and burden on the people. By ignoring these alternative taxes, many analysts have been treating these indirect taxes as essentially costless sources of revenue to the Treasury, and arriving at policy judgements which don't square well with either common sense or history.

The Tax Mix

Looked at in this way, once the level of government expenditures has been determined, it would be redundant to ask what the level of taxes should be. The only remaining question for fiscal policy at that point is to choose the mix of tax revenues which the Treasury must collect in order to pay the government's bills. In principle, it would seem that the desired tax mix—whether all direct taxes (perfectly balanced budget), all borrowing, all printing, or some mixture of the three—ought to be based on a careful analysis of the costs of each form of taxation on the people, in the same way that the choice between an excise tax and an income tax ought to be made. I will briefly outline some preliminary observations along this line farther on in my testimony.

The Historical Preference for Balanced Budgets

Out of all the combinations of the three alternative sources of tax revenue which are possible, it may seem peculiar that one single strategy, balance the budget, has such a strong following. Balancing the budget—that is, a mix of all current tax receipts, no borrowing, and no printing—is the cornerstone of sound budget policy for all good conservatives and for most men-of-affairs. Until recently, to challenge the desirability of balanced budgets would have been political suicide. And yet, over the past two decades, while balanced budgets were being promised on the campaign trails, the actual budget has lived in continual deficit.

Historically, balancing the budget out of current tax receipts served as official and unquestioned Treasury policy during the first 150 years of the Republic. Alexander Hamilton defined the Treasury debt management policy which was to guide Treasury financing operations at least until the 1920s:

> It will be the truest policy of the United States to ... diminish present debts, prevent the accumulation of new debts, and secure the discharge, within a reasonable period, of such as it may be at any time a matter of necessity to contract.
>
> Alexander Hamilton, quoted in
> Andrew Mellon, Taxation, The People's Business, p. 26.

Simply put, Hamiltonian debt management policy says that the government shouldn't borrow, and that if it is forced to borrow--say to finance a war—it should pay the money back (certainly a novel concept today). In fact, at least until the 1920s, the Treasury's definition of ordinary operating expenses of the government included an amortized payment on the principle of the national debt, so that a "balanced budget" in Hamilton's terminology would today be called a surplus.

Hamiltonian debt management policy formed the backbone of Treasury policy during the 1920s. Andrew Mellon is often cited as an early supply sider, since he was responsible for reducing the income tax surcharges which had been erected to finance government expenditures during World War I. In fact, however, he gave the following description of Treasury policy during his term as Treasury Secretary:

> Throughout its history the United States has followed the policy laid down by Hamilton of so funding the public debt that it can be liquidated without undue hardship.
> At the same time the policy has been strictly adhered to that *expenditures for the ordinary operations of the government must be discharged out of current receipts raised from taxes.* Part of the public debt must be paid each year out of current revenues, and such debt as is not paid off must be refunded and the whole eventually extinguished by paying from year to year the amounts accumulated in the sinking fund. (emphasis added)

Andrew Mellon, *Taxation, The People's Business*, p. 26.

A careful reading of Andrew Mellon's own account of his tenure at the Treasury showed that he was not, in fact, a modern day supply-sider. He did engineer significant reductions in the extraordinarily high income tax surcharges in place at the time, a move which he argued would improve work incentives and keep capital from flowing into unproductive tax shelters to avoid the "excessive" tax rates. But that tax rate reduction took place during a period of massive surplus in the Federal budget (even in Hamilton's definition); in the three years leading up to 1923 Mellon had succeeded in paying the national debt down by over 25%; and 11% of the 1923 budget was earmarked for debt repayment. Mellon's tax rate reductions were paid for and justified, in Hamilton's policy guidelines, by the tremendous postwar drop in government spending. Other comments made by Mellon show that he was a staunch opponent of deficits, and that he even believed that retiring the debt would be good for commerce.

> Many people cling to the old policy that debt retirement is bad for business, being the reverse of inflated conditions accompanying vast borrowings. They hold that new borrowings with reduced taxes are preferable to higher taxes with reduced debts. For a moment's reflection will convince anyone that *prosperity cannot come from continued plunging into debt.* As a matter of fact, *orderly debt retirement out of surplus revenues is better calculated to restore prosperity,* for the debt is retired by taxes paid in for the purpose and the money retained for the payment of such taxes is saved from being dissipated in useless expenditures. The payment of debt is particularly desirable when the nation's obligations, as in the case of the United States, are owed to its own people. (emphasis added)

Andrew Mellon, *Taxation, The People's Business*, p. 30.

The Choice of Tax Mix

I believe that the most important argument for balanced budgets, i.e., for avoiding use of the borrowing and printing tax, is found in Adam Smith's advice from the Wealth of Nations.

> Every tax ought to be contrived as both to take out and keep out of the pockets of the people as little as possible, over and above what it brings into the public Treasury of the state.
>
> Adam Smith, Wealth of Nations; pp. 351-52.

This guideline, known as the efficiency axiom, points out the important fact that the revenue generated by a tax and the burden which the tax imposes on the taxpayers aren't necessarily equal. Smith's advice boils down to the common sense notion that the Treasury should opt for an efficient tax over an inefficient tax whenever they have the choice; or, in still simpler language, one should carry water in a pail with as few leaks as possible. As I will argue below, the main justification for balanced budgets is that current tax receipts generally represent, by far, the cheapest way to collect taxes. Based on Smith's efficiency axiom and the estimates I will present below, borrowing and printing should only be resorted to when direct tax collection is not available to the Treasury.

Figure 2 summarizes the key characteristics of the three principal sources of Treasury revenues. The left-hand column points out that the sum of Treasury revenue sources is constrained to equal government outlays. Column (2) points out that while legislative control over who pays current tax receipts is rather tight, control over who pays the borrowing tax is much less tight. Finally, in the U.S., control over the printing tax is entirely unlegislated, and is in the hands of the Federal Reserve Board. In column (3), I also point out that taxes differ in their flexibility, since variations in tax rates seem to be rather slow and clumsy relative to the ease with which government borrowing and printing can be adjusted in a short period of time.

Figure 2
Analysis of Alternative Sources of Treasury Revenue

(1) TYPE OF TAX	(2) LEGISLATIVE CONTROL	(2) FLEXIBILITY	(4) INCIDENCE	(5) NEGATIVE INCENTIVE EFFECTS	(6) BURDEN PER $ OF TREAS. REVENUES	(7) EFFICIENCY
Current Tax Receipts	Tight	Inflexible	Broad Base	Broad	$1.01	High 99%
+Treasury Borrowing	Loose	Flexible	Excise Tax on Security Holders	Savings & Investment	$10	Low 10%
+Printing	Unlegislated	Flexible	Excise Tax on Security Holders	Savings & Investment	$100	Very Low 1%

= Government
Outlays

The real importance of Figure 2, however, lies in the analysis of the final four columns which deal with Smith's concept of efficiency and the related concept of tax burden.

Borrowing as an Excise Tax

Since tax rates are applied to specific economic activities, the incidence of various taxes, or the distribution of the tax burden across the population, varies with the selection of tax structure. In column (5) I point out that current tax receipts fall on a fairly broad base of taxpayers, implying that the resulting negative incentive effects are distributed across all manner of income producing activities in the manner dictated by the tax code.

Borrowing as a source of Treasury revenue, however, does not represent a tax on current income. Instead, borrowing is more appropriately analyzed as an excise tax on holdings of financial assets. From an initial position in which wealth-owners are just content, at current interest rates, to hold the outstanding stock of real and financial assets, new Treasury borrowings of, say, $1 billion, will increase the stock of securities which must be held by the public by an equal amount. Prices of all previously existing financial assets must fall somewhat--interest rates must rise--in order to accommodate the increased supply of Treasury securities. The aggregate amount by which the value of outstanding financial assets has fallen represents a wealth loss to securities holders, and can be viewed as the wealth or excise tax people pay in order to channel revenues to the Treasury through borrowing.

Like all excise taxes, the borrowing tax tends to divert resources away from the activity which is taxed, in this case saving and investment. The borrowing tax does not impinge directly on consumption behavior, in fact, Treasury borrowing activities transfer part of the wealth they have taken from savers to those who have outstanding debts at fixed interest rates. For example, the homeowner with a 6% mortgage will be able to sell that mortgage at a premium if interest rates on new loans were to rise to, say, 10%. Repeated use of the borrowing tax, of course, will show people that those who save money are taxed, while those who borrow and spend their money are subsidized, leading to a serious reduction in saving and investment across the economy as a whole.

The most striking feature of the borrowing tax on the securities markets is how expensive it is. Households across the U.S. currently hold approximately $7 trillion of financial assets. Even excluding short-term deposits, currency and other cash-assets, private holdings of financial assets total over $5 trillion, as reported below in Figure 3. Due to the immense size of these holdings, even a relatively minor increase in interest rates can translate into extremely large losses of current market value of the public's security holdings. CEI estimates, taken from the U.S. experience during the 1970s, indicate that each $1 of Treasury borrowing raises the level of interest rates by an amount which translates into roughly $10 in reduced market value of the public's securities. In other words, it costs the security-holding public about $10 in order to give the Treasury $1. In this sense, borrowing represents a source of Treasury revenues which is approximately 10% efficient, since the Treasury only gets a dime on the dollar. This is a great deal less attractive than the 99% efficiency achieved through current tax collections. On efficiency grounds alone, then, it would seem desirable to avoid regular recourse to Treasury borrowings as a way to pay the government's bills; a balanced budget is nothing more than an implication of sound tax policy.

It is of interest to ask who, among the population, bears the brunt of these taxes. We would expect them to be roughly distributed among the people in proportion to the ownership of financial assets. Figure 3 shows that, in 1981, 62.1% of non-cash financial assets were owned by households and pension funds, and an additional 28.4% were owned by financial institutions. Roughly two-thirds of the assets of financial institutions (or $941 billion) were held as real estate mortgages. Based on this information, one would expect that the borrowing tax falls on people in about the same proportions, that is, the lion's share is paid by households and workers through reduced pension benefits and by the builders, would be homebuyers, and employees in housing-related industries who rely on financial institutions to provide funds for new mortgage lending. From this perspective one could build a strong case that the current plight of the savings and loan industry is the direct result of paying a disproportionately large share of the overall tax burden, which was caused by Treasury financing policy over the past decade.

Figure 3

Ownership of Financial Assets, 1981

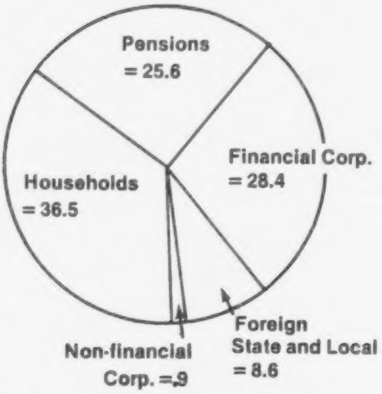


Figure 3 - continued
Ownership of Financial Assets, 1981
(billions of $)

	Mortgages	Corp. & Foreign Bonds	Stock Issues	State & Local Gov. Securities	U.S. Treasury Debt	Federal Agency Debt	Open Market Paper	Total Finan. Assets	Percent Distribution
Financial Corporations	940.7	28.0	7.6	153.6	147.8	139.4	22.2	1439.3	28.4%
Pension Funds and Ins. Cos.	155.8	403.6	444.3	125.8	83.1	59.8	26.4	1298.8	25.6%
Households	133.8	83.3	1080.8	114.5	271.3	69.1	95.1	1847.9	36.5%
Nonfinancial Corporations	-	-	-	3.5	3.7	1.7	36.3	45.2	0.9%
Foreign-Holders/ State & Local Governments	-	22.0	128.3	-	186.5	41.2	56.9	434.9	8.6%
TOTAL	1230.3	536.9	1661.0	379.4	629.4	311.2	236.9	5066.1	100%

This analysis and our estimates of this excise tax show why attempts to stimulate capital expansion by lowering current tax collections without simultaneously reducing spending must fail. For shifting from direct taxing to borrowing, at a fixed rate of government outlays, means substituting an inefficient tax for an efficient tax. The resulting tax burden will rise, not fall. It will discourage the ownership of financial assets and impair saving, thus robbing the capital goods sector of the financing necessary for capital expansion. This is the reason behind my statement at the opening of this testimony; tax cuts alone cannot bring about a capital expansion. In fact, tax cuts which are unaccompanied by spending cuts are likely to bring about a reduction in investment spending.

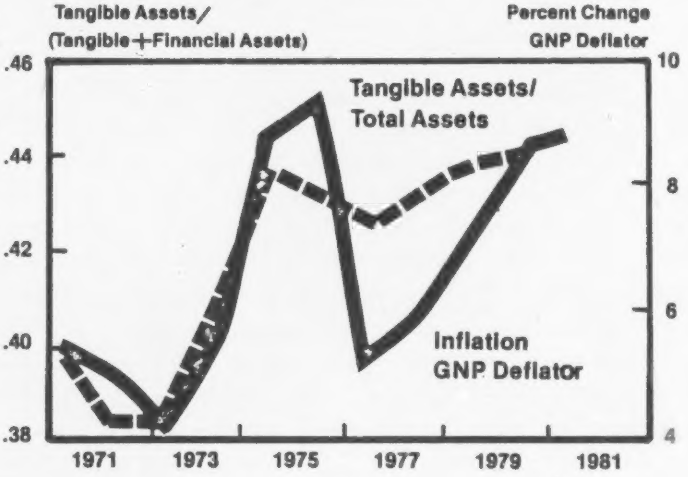
The Printing Press as a Tax

Formally, Treasury revenues which arise as a result of printing money (as a consequence of increased Federal Reserve holdings of Treasury securities) should be analyzed in much the same way. Each $1 in Treasury revenues that comes about due to Federal security purchases results in a $1 increase in the monetary base, and an increase in the money stock (M1) on the order of $2.50. This, over time, leads to a proportional increase in the price level and a rise in interest rates. The rise in interest rates implies a current wealth loss to all owners of outstanding financial assets; this wealth loss is an excise tax corresponding to the increased Treasury revenues.

The nature of the tax burden on the securities markets caused by money supply increases is illustrated in Figure 4. During the 1970s, growing reliance on money supply increases led to a rising inflation trend. As the inflation rate rose, households attempted to increase their holdings of houses, collectibles and other real assets at the expense of their holdings of financial assets. The resulting selling pressure on financial assets forced major declines in the market values of stocks, bonds, and other securities, and increasing interest rates. These wealth losses on security portfolios measure the excise tax which money printing as a source of Treasury revenue imposes on the security markets. CEI estimates suggest that, due to the devastating leverage that increases in the monetary base have on the price level, each $1 in Treasury revenues raised through money printing will cost security holders about $100 in lost market value. This leads to an efficiency measure of only 1% for this third source of tax revenues.

Figure 4

Inflation and Asset Holdings of the Private Sector (1970-1979)



The Arithmetic of Tax Collection - 1981

Putting these estimates together with the 1981 record we can make a preliminary estimate of the total burden of government finance on the capital markets during the year. In fiscal 1981, the Federal government spent $667 billion. Of that total $613 billion was raised through current taxes, $46 billion was borrowed from the public and $8 billion found its way into the monetary base. The sum of borrowing ($46 billion) and printing ($8 billion) equals the recorded Federal deficit for 1981 of $54 billion. Using the efficiency measures presented earlier, the $613 billion of tax revenues cost the public about $619 billion, the $46 billion that was borrowed caused a $460 billion reduction in securities values, and the $8 billion that was printed wiped out another $800 billion in security values. In total, we paid the government $1879 billion so that they could pay $667 billion in bills. All in all, not a very efficient tax policy.

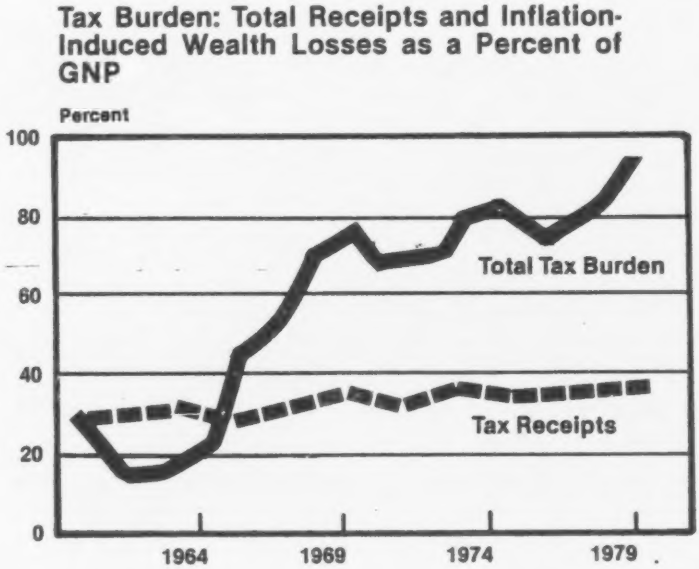
Figure 5
The Arithmetic of Tax Collection - 1981
(billions of dollars)

	Actual Revenues		Effect of Moving to a Balanced Budget	
Treasury Revenues	1981 Revenues	Tax Burden	Treasury Revenues	Tax Burden
Taxes	613	619	667	674
+Borrowing	46	460	0	0
+Printing	8	800	0	0
=Total	667	1879	667	674

The two right-hand columns of Figure 5 illustrate the tax burden consequences of a hypothetical move to a balanced 1981 budget. Paradoxically, what looks like a $54 billion tax increase turns out, in fact, to be a $1205 billion reduction in the burden of the taxes—or tax rebate—on the tax-paying public. Further, this rebate would have been put in the hands of savers and investors, rather than given to the public at large. In our analysis, such a tax rebate would be likely to have positive effects on capital formation, hence a dramatic improvement in long-term productivity and real wages.

Calculations of the total burden of Treasury revenues on the economy since 1960 are compared with standard measures of total (Federal, State, and local) tax collections in Figure 6. Whereas current tax receipts as a share of GNP only rose from 28% to 35% over this 21 year period, the total tax burden, including its security market effects, rose much faster. During the early 1960s, governments neither borrowed nor printed to the extent they do today. As a result there were extremely strong stock and bond markets leading investors to make ample funds available for capital investment. As illustrated above, the reduction of borrowing and printing in the early 1960s could be viewed as a tax rebate. In Figure 6, that rebate, or subsidy to saving and investment, is measured as the excess of tax collection over the tax burden, which at times equalled as much as 10% of GNP. Our estimates suggest that this "tax rebate" may have been a much more important cause of the savings and investment boom in the mid-60s than the Kennedy tax cuts, which typically get the credit for that boom.

Figure 6



Tax Burden: Total Receipts and Inflation-Induced Wealth Losses as a Percent of GNP

But the low tax burden was not to last. The mounting cash needs of both the Vietnam War and the War on Poverty forced the Treasury to resort more and more to non-tax sources of finance; as a result the total tax burden climbed to the 60-80% of GNP range during most of the 1970s. The falloff in savings and investment and slowing of productivity were coincident with the imposition of this massive wealth tax on the securities markets. The housing problems, the savings and loan solvency question, the corporate liquidity problems that we face today are, in my opinion, direct results of this unbearably high tax burden. It would seem that the only solution for these problems is to restructure the tax policy so as to follow the principles that Hamilton laid out 200 years ago. Don't borrow, don't print, and pay your bills as you go.

A	L
CAPITAL STOCK	FINANCIAL MARKETS

FIGURE 1

SIMPLIFIED BALANCE SHEET FOR THE ECONOMY

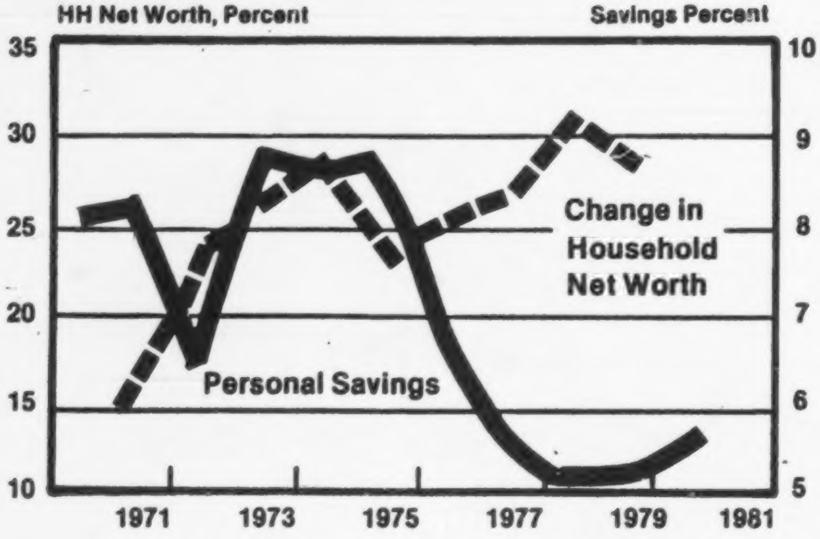
(1) TYPE OF TAX	(2) LEGISLATIVE CONTROL	(3) FLEXIBILITY	(4) INCIDENCE	(5) NEGATIVE INCENTIVE EFFECTS	(6) BURDEN PER $ OF TREAS REVENUES	(7) EFFICIENCY
Current Tax Receipts	Tight	Inflexible	Broad Base	Broad	$1,01	High 99%
+ Treasury Borrowing	Loose	Flexible	Excise tax on Security Holders	Savings + Investment	$10	Low 10%
+ Printing	Unlegislated	Flexible	Excise tax on Security Holders	Savings + Investment	$100	Very low 1%

= Government Outlays

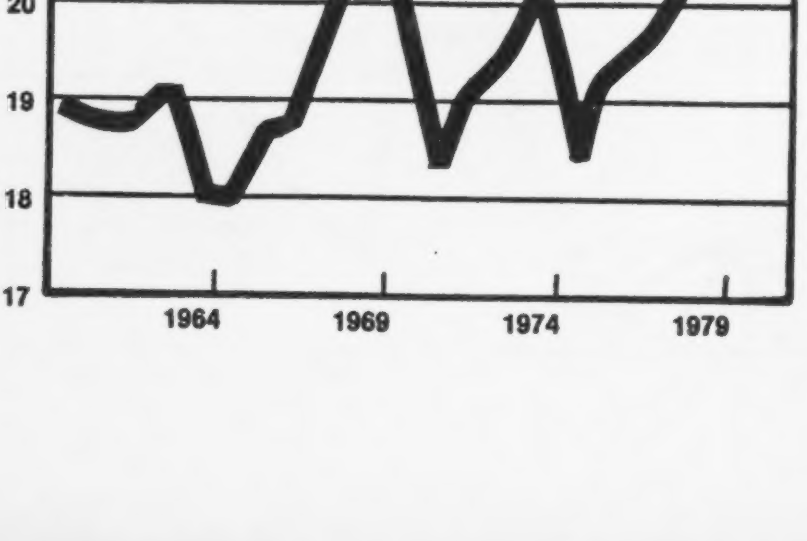
Figure 2

Analysis of Alternative Sources of Treasury Revenue

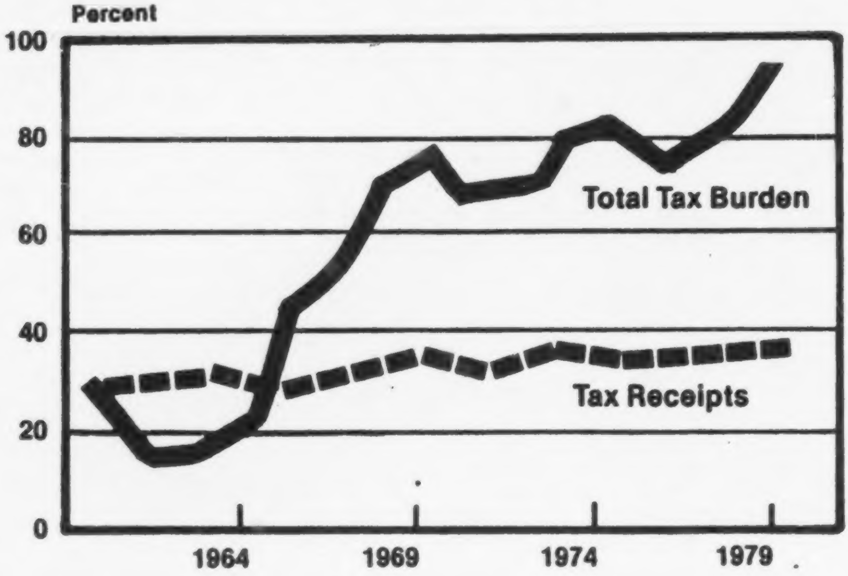
Personal Savings and Change in Household Net Worth as a Percentage of Disposable Personal Income



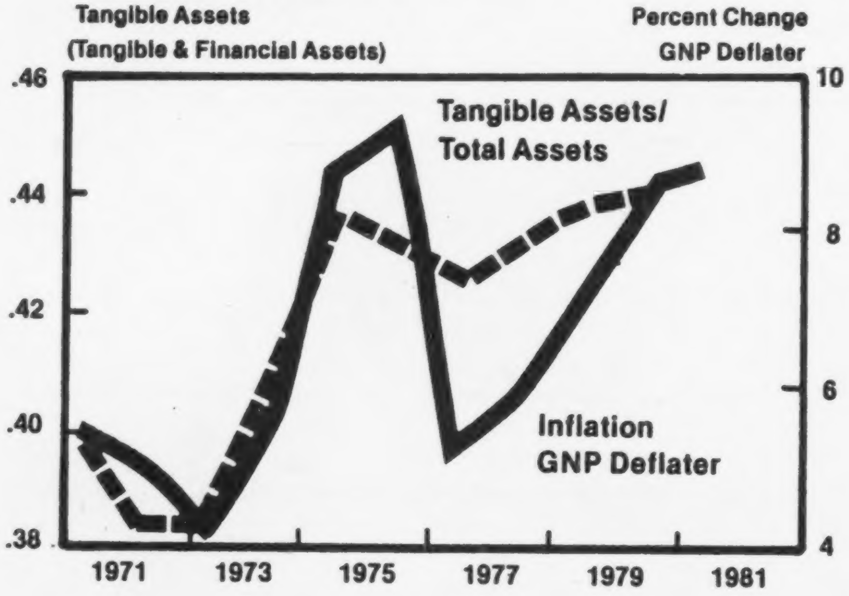
Federal Tax Receipts as a Percent of GNP



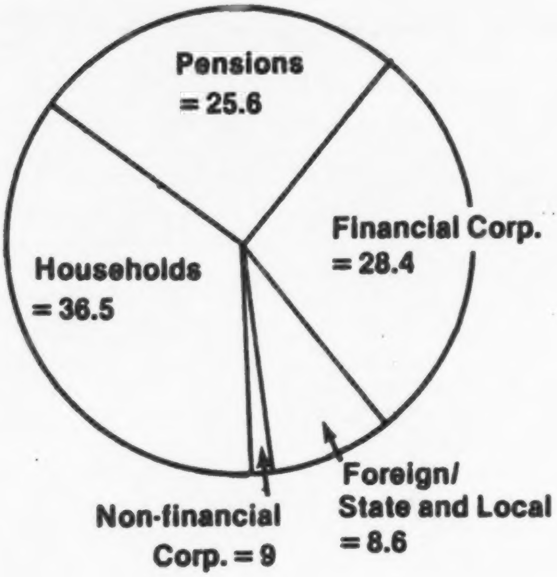
Tax Burden: Total Receipts and Inflation-Induced Wealth Losses as a Percent of GNP



Inflation and Asset Holdings of the Private Sector (1970-1979)



Ownership of Financial Assets, 1981



Chairman **Domenici**. Dr. Son?

STATEMENT OF SUNG WON SON, SENIOR VICE PRESIDENT AND CHIEF ECONOMIST, NORTHWESTERN NATIONAL BANK OF MINNEAPOLIS

Dr. **Son**. I have a short statement, and I did not bring any fancy charts, so I will just read my brief testimony, Mr. Chairman.

The Nation was promised a vibrant economy and lower interest rates when the Economic Recovery Act of 1981, which provided the largest tax cut in this century and the sharpest cutbacks in domestic spending in five decades, was enacted.

Today, the economy is in a recession, as we all know, interest rates are at lofty levels, and the financial markets are reeling from the prospect of record Federal deficits over the next 4 years. If off-budget outlays are added, the administration figures indicate that the national debt, which reached $1 trillion in fiscal year 1981, will climb to $1.4 trillion by 1985, an astronomical figure.

Private estimates of budget deficits for the same period are as high as $500 billion excluding offbudget outlays, which add another $100 billion. The national debt, then, will reach $1.6 trillion, a 100 percent increase from the 1978 level.

Now, looking ahead, the economy may not perform as well as the administration hopes unless deficits and interest rates are brought down. The economy could be caught in a vicious circle in which huge deficits push interest rates up. With high and rising interest rates, the economy would become weaker, increasing deficits.

But, couldn't the deficits be financed by increases in the savings rate, as the supply siders suggest? Historical evidence argues against such optimism. Back in 1964, personal tax rates were cut, and the savings rate increased from 5.4 to 8.1 percent. A decade later, the savings rate fell from 8.6 to 5.7 percent, when inflation was pushing everyone into higher tax brackets between 1975 and 1980. On the other hand, the savings rate in Great Britain rose despite the rising tax rate. The savings rate in the United States has been much higher in the postwar period than it was in 1929, when tax rates were much lower.

SAVERS PURCHASE FUTURE INCOME

Saving to me is postponement of present consumption. In other words, savers purchase future income. Saving incentives like a tax cut make future income cheaper, making savings more attractive. On the other hand, the tax cut enables savers to purchase the same amount of future income with less savings. The savings rate may actually decline as a result of a tax cut.

Further disputing supply-sider's claim is Denison's law. It states that the ratio of savings to GNP remains stable over time. For example, the ratio averaged 16.45 percent between 1953 and 1980. Very rarely did the ratio deviate much from the average. The administration projects that the ratio would rise significantly; this flies in the face of Denison's law.

The above discussion does not say that savings incentives have no effect on savings. Of course, it does. However, it does say that incentives like a tax cut is not the most important motivating force behind savings. People save toward goals: Purchase of a house, a *trip to Europe, financing of college education, et cetera.*

As far as President Reagan's economic program is concerned, there is a lot of risk in counting on increases in the savings rate to finance a significant portion of the deficit.

How important are deficits? In a recent speech, President Reagan has said that deficits are necessary evils. Courageous supply siders have argued that deficits really do not matter.

I believe deficits do matter a great deal. Deficits have two important economic impacts. First, deficits absorb a significant portion of private savings, putting pressure on interest rates. Housing, auto, agriculture, exports, and investments are hurt. In fact, the supply-side effects cannot operate with high interest rates.

Second, deficits have a strong psychological impact on the economy. Economists can argue for days and weeks as to whether deficits do or do not matter. But the fact of the matter is the average person in the street and participants in the financial markets do worry a great deal about deficits. They tend to equate deficits to high inflation and interest rates. As Treasury Secretary Regan said, "Deficits really spook money market traders. When they hear these high numbers, they just go bananas, and interest rates rise."

DIRECT LINK BETWEEN DEFICITS AND INTEREST RATES

As a practicing economist in a financial institution, I can confirm what the Treasury Secretary has said. In the real world, there is a direct linkage between deficits and interest rates. One of the reasons behind the linkage is risk premium. Lenders, staring at a series of monumental deficits, worry that political pressures will compel the Fed to finance them with inflationary monetary expansion. The administration has contributed to uncertainties as well, and therefore, risk premium.

Economic projections coming out of the administration have been overly optimistic in the past. Deficit estimates have been raised repeatedly. Integrity and consistency of the administration's economic assumptions have been questioned. The point is that all these worries and uncertainties add to risk premium keeping interest rates high.

So the ballooning deficit estimates are extremely troublesome. What do we do about them? I believe Congress has to take some painful steps to reduce the deficits. Otherwise, the economy could experience annual economic recession. But, before I go into my recommendations, I would like to discuss my philosophies on supply-side econonics.

REAGAN POLICIES CORRECT IN DIRECTION BUT NOT IN DETAILS

Despite my earlier criticisms on supply-side economics, I consider myself a supply sider. The policies President Reagan has put into place last year are correct in direction, but not in details. Supply-side policies can do a lot for the economy. However, any good theory or policy will fail if too much is attempted in too short a time. President Reagan's economic policy should have taken smaller steps and allowed more time for the supply-side theory to work.

I believe that it is not too late to make adjustments in the President's program.

What are my recommendations?

First, I would make the timetable for the tax cuts flexible. Tax cuts should be tied to the performance of the budget deficit. Once a certain goal for reducing the deficit is achieved, the next phase of the tax cut would be phased in.

Second, the projected buildup in defense spending should be slowed. I am not a defense expert, but I believe more money does not necessarily buy better defense. In addition, economic security is an important part of our national security. For these reasons, the kind of program proposed by our able senior Senator Rudy Boschwitz should receive serious consideration. As you know, Mr. Chairman, he has proposed that the defense buildup should be slowed to 12 percent per year, instead of 16 percent per annum over the next 4 years. In fact, there is support, I believe, for decelerating defense spending even further, more rapidly. Ultimately, only a healthy and vibrant economy can pay for a strong defense program.

Third, temporary increases in taxes for individuals and businesses should be considered. The temporary increases in taxes would serve to reduce deficits in the near term. Once the economy picks up and deficits are brought down to tolerable levels, the permanent cut in the tax rate would be restored, allowing the supply-side effects to take place.

ECONOMY IN DEEP TROUBLE

In summary, I believe that the economy is in deep trouble, and as I pointed out earlier, unless we do something about it, there is a chance we could go into an annual recession mode, which would be very tragic for the U.S. economy.

The stop-and-go economic performance has weakened our economic fabric, reducing our ability to weather significant external shocks.

In order to revitalize the economy, the reduction of the Federal deficit ought to be the top priority. With a reduced budget deficit, the total credit demand would diminish, and the Federal Reserve Board would have an economic, not a political, reason to ease monetary policy. Lower interest rates would follow, reviving the economy. Deficits would fall further and inflation expectations would diminish. Risk premium in the financial markets would be cut. In short, supply-side economics would be given a chance to work. I believe this is really all we want.

Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you very much, Doctor.

Dr. Rutledge, you gave us your theory of taxation as it relates to your definition of capitalism. Basically, I agree with your notions, but I wonder if you could tell me—take the position we are in now as a country, not where we were, and give us a couple of recommendations, or at least your ideas, of what we ought to do. Maybe we ought to lay a little groundwork and say, if I read you right, you would be saying, consistent with social policies, things we can get by with in terms of our broad responsibilities, that we ought to cut the budget—that is, the outlays of Government—as much as possible. That seems to me to be inherent in what you are saying, that we have got to do that.

PRIVATE PEOPLE DO BETTER JOB OF CONTROLLING RESOURCES

Dr. RUTLEDGE. That is right. The notion there is that when resources are controlled by private people, they do a better job of it than if they are controlled by Government agencies.

Chairman DOMENICI. If you have done that to the maximum and reduced in a credible way the level of expenditures of your Government over a period of time, then your thesis would demand that the next thing we do, if I understand it, is to bridge the gap and revenues as much as possible. If that gap is very large with existing revenues, bring it down as much as you can; if that is very large, then you would address that next and say how do you get that down. You would not attempt to get the interest rates down by loosening the money dramatically because you construe that ultimately as a tax on capital and the most efficient tax on capital; it is the most destructive, in your opinion.

Dr. RUTLEDGE. That is right.

Chairman DOMENICI. So you would not loosen money dramatically. You would mininize the deficit any way we could, once we have reduced the budget as much as possible; is that correct?

Dr. RUTLEDGE. That is right. In perspective, against the Reagan program, the announcements, the first set of announcements made a year ago had a reduction in Government spending from 23 percent of the economy to 19 percent planned over a 5-year period. That reduction in spending is the point which, to me, is paid for in tax cuts which accompanied that. So that you had a budget which was balancing less borrowing each year over that time. That is a sensible policy.

If, now, we are looking at a budget which calls for 23 percent of the economy consistently over 5 years, then the idea of cutting current tax receipts below that does not make any sense.

Chairman DOMENICI. Yes, but Dr. Rutledge, that game plan that you just described did not contemplate any larger budget cut than have already been made to this point in history. It contemplated more in the future, but Congress just about, as I recall, gave the President his expected budget reductions to this point in time. You did not expect—I assume you did not expect—the economy to be in this kind of shape after you did those things, did you?

RECESSION HAS PULLED INFLATION RATE DOWN

Dr. RUTLEDGE. Well, the recession we are in the middle of right now is on the order of what you can expect from this kind of monetary tightening we have had. It has been more aggressive than most people thought or wanted, but it has also pulled the inflation rate down that much faster, too, and to me, may well be worth the price we pay for it.

Chairman DOMENICI. Well, did you expect that?

Dr. RUTLEDGE. I expected a recession. I expected for 1982 essentially not much growth to happen, but a very large and fast rapid drop in the inflation rate. I also, though, I have to admit, expected interest rates to fall a lot faster than they have, and we can go into arguments about why that has happened or not. We were wrong on that, but right on the inflation side.

But on the recession, I think this is not out of the bounds of reason of what you would expect from taking a period of rapid printing of money and just stopping the printing press, which is what has happened in the last 2 years.

Chairman **Domenici**. Well, here is the problem, though. If you take the President's budget requests–you said everything was kind of all right at the beginning, because you saw the trend line for the budget outlays over a period of time coming down; you could therefore reduce taxes, and the ultimate gap was nonexistent because it predicted balance within a reasonable period of time.

GAP MUST BE CLOSED

If we were to now put in place the fiscal restraint contemplated originally, quantitatively—maybe it is a different mix, but it is going that way—and leave everything else alone, the gap may still be $100 billion. That is what confronts us at this point, which seems to mean we have got to change something if we buy the original notion. Is that not correct?

Dr. **Rutledge**. Yes, it is; if that is in fact true, then that gap must be closed. Some of that is due to the effect of the recession on shortfall on tax receipts and all that. It does not make sense to try to make that up to change the tax rates. That is what budget deficits are for, to act as a shock absorber, but there seems to be a large difference of opinion about how much of it is that and how much is the other.

Chairman **Domenici**. All right. So the two of you started 1½ years ago on the same wavelength, if I read you right. You both were saying, "We are doing the right thing;" that is, Dr. Roberts and Dr. Rutledge.

Now, you have just given your explanation of where we are and what we ought to do, which I gather is perhaps a less dramatic moving toward balance, but moving there nonetheless, because you would not try to pick up some of the unexpected shortfalls and the like.

Now, Dr. Roberts, you were together back then, and you are obviously not together now. Why? What happened?

Dr. **Roberts**. I do not know in exactly what sense we were together then or in what sense we are not together now. I have been listening carefully to John this morning. I think that one point I stress is that we did not get the President's policies. Perhaps you would say, well, they got a good bit of their expenditure reduction, but not as a percent of GNP; Federal expenditures as a percent of the size of the economy have risen successively in both years of the Reagan administration. Carter held the all-time record in peace time of 23 percent of GNP, and the first year of the Reagan administration it went up to 23.7, and then this year, it is projected to be 24.2, and everyone says that those numbers are phony because you are not going to get the spending cuts, so it is more likely to be 25 percent.

NONE OF THREE COMPONENTS SUCCESSFUL

So it seems to me that spending as a percent of the economy is on the rise. So that would have to be seen as a defeat for the budget policy. For the tax policy, I see that was also defeated, because it was held hostage to keeping tax rates high in order to balance the budget, so the tax cuts were successively delayed and scaled back and lie mainly in the future. So you then add to those two failures a third—the monetary policy. We did not get a monetarist monetary policy, which would have been a steady, moderate growth of the money supply, at lower levels than the inflationary levels of the past, but not tight, in the sense of zero money growth for 6 months.

So I do not believe we have any of the three components of the policy. I do not know what success they have had on regulatory policy. But I do not believe we have any of the three. And now, Mr. Chairman, for whatever the reason, we do have a recession.

Now, what bothers me is if we focus on the deficit rather than the recession, and we take steps, for example, to further cut expenditures in the recession, now, I can imagine the Congressional Budget Office going bananas over this idea of deflating demand at a time when demand is falling, because in the whole Keynesian view of the world, which is still predominant, in spite of a few supply siders here and there, that would be seen as an extraordinarily destructive step, to further collapse demand at a time when demand was falling.

The same interpretation would hold to any tax increases or to further postponing any tax cuts, because at a time when cash flow is restricted, when demand is faltering, you would not normally undertake policies to encourage further restriction of cash flow and a further faltering of demand.

NOT IN FAVOR OF RUNNING PERPETUAL DEFICITS

So that is what bothers me. It does not mean that I think deficits are good, or that I think that they are a policy tool in the way the Keynesians think, or that I think they are unimportant. I am certainly not in favor of running perpetual deficits, either.

The point that the Reagan administration originally had in mind was to try to balance the budget with policies that would kick up the real rate of economic growth, thereby adding to revenues relative to expenditures, and in that way, balance the budget through economic growth. We do not have those policies. We have the prospect, perhaps, of them coming in the future if they are not repealed or postponed. In the meanwhile we do have a recession.

So the question is, How do you treat or react to a deficit when you are in a recession. I think it is a great risk to make the deficit the primary focus of policy until you see your way out of the recession.

Chairman DOMENICI. Well, it is amazing what you assume the so-called Keynesians at CBO And elsewhere would be saying, they are not saying—not at all—they are not suggesting that dramatic budgetary cuts which basically have no impact for the remainder of 1982—they are not saying that dramatic budget cuts are going to have any adverse effect. So either they have left their rigidity, or they are adopting the notion that you have to do that to get the interest rates down, because of perhaps some of the ideas that we have got to build capital back some way.

We have no one coming out of any economic school telling us that you take any serious economic risk if you exceed the President's recommended cuts even twofold over the next 3 years—1983, 1984, and 1985.

Dr. ROBERTS. Well, that means that the Keynesians have completely evaporated, then. I am not a Keynesian, but it frightens me.

Chairman DOMENICI. Well, I do not see very much difference between the Keynesian and what you are recommending.

LOWER THE INTEREST RATES WITHOUT COLLAPSING THE ECONOMY

Dr. ROBERTS. Just one point. You see, there are different ways to get interest rates down, and the thing that you want to avoid is not to get them down because you have collapsed the economy. I think even John would agree with that, that you do not want to have interest rates falling because you have managed to worsen the recession by further tightening on demand, on the cash flow position of the private sector.

If you can get them down without doing that, there is nothing but gain to come from it.

But we also have the question of why we have these high interest rates, and that really has not been addressed. And I think sometimes, we tend to take it for granted that it is a result of the deficit. But that is a rather new departure in interpretations of our experience. Also, if you think what the interest rates were in January 1981, the prime rate was considerably above what it is now, and the deficits were projected at half the size. So it would seem to me that if there was a correlation between the fear of the size of the deficits and the interest rate, that the interest rate now should be around 25 percent, rather than 16.

I think also, one other point, Mr. Chairman, that if you think about our financial markets and the people who operate in the financial markets, for the last 20 years, they have known nothing but deficits and rising deficits. It is the only environment that people in the financial markets who operate there have ever known. For 20 years, they have seen rising deficits, they have seen rising interest rates. That is their life experience. So why, all of a sudden, are these people, who know no other experience, panicked by rising budget deficits?

Chairman DOMENICI. Well, I think the one explanation is a common, ordinary businessman's interpretation of his charts. I think the printing of money and the deficits were a huge tax on capital formation, and it has now dawned on everybody, and it was dawning on them in pieces over the previous decade. They were getting there, but they were once again willing to go to the bond trough and put it up for 20 years, and they have now concluded, as I have said a number of times, that the adage around, the best way to become a millionaire in the bond market is to invest $2 million, is just pervasive. That is how I see it. Everybody I talk to says that is exactly why they are not going to come down, because we are not going to take those chances again.

I want to make one last point and then ask Dr. Son if you have any comments, and then go to Senator Exon.

One thing, Dr. Roberts, I do want to stress, because it has become very important to the members of this committee; if they were here, they would speak for themselves, and I wonder if you would care to address it.

Whether you take the President's economic assumptions or CBO's, for 1983, 1984, 1985, and 1986, it is different than we have had before because we are predicting growth, probably as good a 4 years in that scenario as we have had but for one other 2-year period, since the war. We are predicting employment up—all of those good things that make the Treasury fatter, and all of the negatives get wrenched out of a normal budget. But we have deficits exceeding $120, $130 billion. Now, that is slightly different than we have had. Does that concern you?

SPENDING OUT OF CONTROL

Dr. ROBERTS. Well, I think it does, because it shows that spending is out of control. As I say, the Reagan administration was going to cut taxes and was going to cut spending. Yet, this year, in spite of the tax cuts, Federal revenues are a higher percentage of GNP than they were in 1980, the last year of the Carter administration, which was a high-tax administration.

The same for public expenditures. They are higher as a percentage of GNP than they were in 1980. So, what we have is that both tax revenues this year, 1982, and expenditures, are continuing to grow more rapidly than the economy that supports them.

So, yes, it does concern me very much.

Chairman DOMENICI. That is partially because we have not cut as much as we should and because of defense, but it is also partially because of the recession, on both sides. It affects the taxes and it affects the GNP dramatically.

Dr. ROBERTS. That is right, and that is why I think it points to the importance of having the economy grow faster than expenditures.

Chairman DOMENICI. The President's budget would not have us in that status by 1985, however. We would have the deficits, but it would be down. The percentage of expenditures versus GNP and the rate of tax versus GNP would be substantially down over the last Carter year. The missing link is that there is $130 or $140 billion deficit in there, and we are asking can you get there. You make those nice projections, but can you get there with those kinds of deficits, or will it be self-defeating. I think that is part of the concern.

Dr. ROBERTS. I do not know how much confidence I would place in any out-year budget projections. They may be too optimistic; they may be too pessimistic.

Chairman DOMENICI. I agree.

Dr. Son, did you have a comment?

Dr. SON. Well, I obviously disagree with Dr. Roberts. While the tax cuts may stimulate the economy, and that is what the econometric models would tell you, and the effect on the economy obviously is positive, but I do want to point out that first of all, this economic recession is a direct result of high interest rates, and in my memory, that is the first time during the postwar period. And as I say, until and unless we do something, we can get into an annual recession mode, which could weaken the economy severely and that reduces our ability to withstand any kind of external shock.

The point that I want to make is let us look at the positives and negatives. The negatives are high interest rate as a direct result of budget deficits. That weakens the economy—housing, auto, farm economy, et cetera—so that when you balance the two, the net effect is a negative.

DON'T UNDERESTIMATE PSYCHOLOGICAL IMPACT

Now, a lot has been said about the impact of the budget deficits. Again, I would like to emphasize the importance of the psychological impact of the budget deficit. I used to be a specialist in econometrics when I was in graduate school, but if I have learned anything since I left graduate school, it is how important psychological impacts are. And that should not be underestimated. This, to me, is really the missing link, not emphasizing enough of this psychological impact.

Chairman DOMENICI. All right. Senator Exon, if you would address your questions first to Dr. Roberts, because he is on a very tight time schedule.

Senator EXON. I understand, and I just wanted to get one or two thoughts from you before you leave, Dr. Roberts, and then I have some things that I would like to go into with the other distinguished members of the panel this morning.

I would like to quote from a part of Dr. Son's statement. He says:

> First, I would like to make the timetable for tax cuts flexible. Tax cuts should be tied to the performance of the budget deficits. Once a certain goal for reducing the deficit is achieved, the next phase of the tax cut would be phased in.

I would like to get your idea on that, Dr. Roberts, for several reasons, not the least of which is I agree completely with Dr. Son. I introduced twice last year amendments that were brushed aside, basically because of pressure from the White House, because we kept getting the word down that we dare not tamper with the magic formula which had been introduced. And I wish, Dr. Son, if you had been advising Senator Boschwitz at the time, you might have prevailed upon him to have supported what I suggested along these lines.

TRIGGER MECHANISM

What I suggested basically was to go to a trigger mechanism, we will reduce taxes "if", and the "if" was based upon meeting the deficit projections and the interest rate projections on which the program was based. And my specific proposal was that we would not go to the third year, the July 1984 individual tax cut; we would cut that in half if we had not met, by the end of this fiscal year, the deficit projections of the administration.

So, I think a trigger to reducing the level of expenditures of the Government is quite important. I was wondering, Dr. Roberts, what you think of that.

Dr. **Roberts**. Well, I think, Senator, that the markets would have discounted the tax cut in that case, in fact, they would never have expected to receive it. I think they would have simply taken the trigger as evidence that spending would not be reduced, and therefore, you will——

Senator **Exon**. Well, if you say that, then, you are also saying that the markets did not believe the interest rate projections and the deficits embodied in the Reagan proposal; is that right?

Dr. **Roberts**. I do not think they believed the tax cut, even without the trigger, particularly with all the talk about repealing them and yanking back part of them.

Let me respond to your question, here. Dr. Rutledge has a nice little book of quotes here. Here is one from Andrew Mellon, and it is called, "The importance of stable tax rates." It says:

> A permanent tax system should be designed not merely for one or two years, nor for the effect it may have on any given class of taxpayers, but should be worked out with regard to conditions over a long period of time and with a view to its ultimately effect on the prosperity of the country as a whole.

UNCERTAINTY ABOUT TAX RATES FRUSTRATING

So, I think the trouble is, if you try to achieve certainty in one part of the system by having uncertainty in the tax code about what the tax rates are going to be, that you just sort of frustrate yourself.

So, in principle, one could understand the notion you are talking about, but I think the effect in the market would just be that people would discount the tax cut altogether, and they would discount any prospect of control over expenditures. And I think that would be the result of the trigger, in practice.

Senator **Exon**. You remember that I clearly said the individual tax cut; I did not propose to leave the 3-year business cuts in place. That would not have had any effect on the anticipation of the market?

Dr. **Roberts**. Well, Senator Dole is already talking about taking back part of the business tax cut. So whether it would have been——

Senator **Exon**. I am not talking about Senator Dole's proposal. I am talking about Senator Exon's proposal.

Dr. **Roberts**. But I am just showing you that these proposals have the effect of making the changed tax law very uncertain, and therefore, I think it would be completely discounted that people would ever get those tax cuts.

Senator **Exon**. Well, what you are saying, then, is whether we have the trigger or not, the money markets do not believe we are going to do what we projected we were going to do, even under the Reagan proposal that had the blessing of the President.

GOVERNMENT HAS CREDIBILITY PROBLEM IN MARKETS

Dr. **Roberts**. I think government in general has a credibility problem in the markets. I think John Rutledge would agree with me.

Senator **Exon**. Even President Reagan?

Dr. **Roberts**. Even President Reagan——

Senator **Exon**. Even President Reagan. That is hard to believe, but I thank you.

Dr. **Roberts**. The Reagan administration.

Senator **Exon**. I thank you very much.

Dr. **Roberts**. They may believe the President more than they believe anyone else.

Senator **Exon**. Well, they may want to believe the President more than they want to believe anybody else.

Dr. **Roberts**. He cannot make things happen all by himself. We have a President not a king.

Senator **Exon**. We have what?

Dr. **Roberts**. We have a President, not a king. A President is constrained by his own government and by the Congress and by all kinds of other things.

Senator **Exon**. I thank you.

I have some other questions I would like to go into a little bit. Dr. Son, you represent one of the largest financial institutions and a very important part of our economy known as agriculture. And I do not know whether or not as an economist you get into the present situation of the banks with regard to agricultural loans.

I have generally had the feeling that with the severe downturn in the agricultural economy and near depression level returns——

Senator **Quayle**. Excuse me, Senator Exon. May I ask Dr. Roberts a question before he leaves?

Senator **Exon**. Go ahead. I yield to Senator Quayle. He wants to ask Dr. Roberts a question.

Senator **Quayle**. Before you leave, I just wanted to ask you a couple of questions on the deficit. Does the size of this deficit matter? Is the size of the projected deficit of the administration budget cause for alarm in slowing down the economic recovery plan that has been adopted?

UP-FRONT DEFICITS NO LARGER THAN PREVIOUSLY EXPERIENCED

Dr. **Roberts**. Well, the up front deficits, Senator, are no larger as a percent of GNP than we have experienced in previous recessions. In fact, the projections of the up front deficits are actually smaller than the deficits that accompanied the 1974–75 recession. And those deficits, which were larger as a percent of GNP, did not prohibit a recovery. So normally, economies, when you have recessions, have big deficits, and all recoveries have to take place in the face of those deficits.

The out-year deficit projections, what you make of those depends on how much confidence you have in those numbers. What you would want to be sure to avoid is worsening those deficit projections in the out-years by prolonging the recession, or implementing policies that could make the recession worse. If you do that, then you will impact more severely on those future deficits. And that was the message of my short, five-page testimony before the committee, that you want to be sure that in a period of falling demand and restricted cash flow, you do not undertake policies that would further reduce demand and cash flow.

Senator **Quayle**. In other words, the suggested deficit by the administration budget, $91 billion, assuming that Congress cuts about

$50 billion, which Congress says it is not going to cut, is really, if you do not get to some sort of a bipartisan agreement, about a $150 billion deficit in 1983. That does not bother you?

Dr. **Roberts**. Well, that would be roughly in keeping with—yes, about 4.5 percent of GNP.

Senator **Quayle**. So that does not bother you?

Dr. **Roberts**. Well, I do not know what you mean by it does not bother me. I certainly do not look at it as any great benefit. But when I match the bottom line, I have to know what is the alternative, and it is unlikely that I am going to reduce that deficit in a recession by raising taxes. I do not believe it is conceivable, because you may simply worsen the recession, thereby widening the deficit. That was the main point of my testimony.

So when you say does it bother me, it bothers me in the sense that if I could wave a wand and make it go away, I would wave it.

SEARCH FOR ALTERNATIVES TO LOWER DEFICIT

Senator **Quayle**. But don't you think that we ought to search and try to come up with some alternatives to get that deficit down, since it does bother you? I mean, I know maybe we are not going to do it just by raising taxes; perhaps the taxes are going to have to be part of it. But more importantly, what bothers me is that you and some others say that the deficits really do not matter——

Dr. **Roberts**. No, sir, not me.

Senator **Quayle**. Or, do not matter that much, and in relationship to the past recessions, they are not any greater as a percentage of GNP, so therefore, that should not be an overriding concern of the Congress, if I can paraphrase.

It certainly appears that the business sector thinks that these deficits are out of balance and are very serious, and the American people feel that they are very serious. The psychological factor is very, very important. It is a very, very important factor, and that is why I do not think we can just walk away from these projected deficits. They are huge, even though you say that they may not be any different in relationship to the GNP in other recessions.

Dr. **Roberts**. That is right, they are not.

What frightens me about attacking a deficit in a recession is that I believe the last time that was done was Herbert Hoover. And I think the last time someone tried to balance the budget when the economy was collapsing was President Hoover, and I think there are great dangers in that approach to public policy. If I was certain that you could raise taxes and further reduce demand in a recessionary context and succeed in balancing the budget, I would be much less worried about that course.

But before I would be happy with a policy like that, I would want to know exactly what has happened to the Keynesians; where are they? Are they prepared to have demand further collapsed in a recession and expect no bad effects from it, because if you do have any of the relationships operating in the economy that the Keynesians have assumed all these decades, and you take that course of action, then you may end up reducing the interest rates, because you have worsened the economy. And I do not think that would be a gain to have interest rates collapsing because the economy was collapsing.

BE CAUTIOUS DEALING WITH BUDGET DEFICIT DURING RECESSION

So it is not that the deficits do not bother me, and it is not that I am a Keynesian, but it is that I would want to be very cautious about what looks to me like a very deflationary approach to dealing with the budget deficit in a time of recession. That is my only point.

Senator **QUAYLE**. But the time of recession is hopefully 1982 and not 1983; right? Are you anticipating a recession in 1983, as well?

Dr. **ROBERTS**. Well, I think if we take the deflationary policies that we are talking about, we run the risk of having a recession in 1983, as well, yes. But I do not see the recovery yet, and I would be much less concerned if I saw the recovery.

Senator **QUAYLE**. So you do not see a recovery coming in 1982?

Dr. **ROBERTS**. Well, it is not that I do not see it; but it is not here right now. It seems to me we are focused on the wrong issue—the deficit rather than the recession. That is what bothers me.

Senator **QUAYLE**. But you do not see a recovery in 1983?

Dr. **ROBERTS**. I do not see a recovery independently of the policies adopted by the Government. I do not think recovery just comes in out of the blue or does not come in out of the blue. It is a function of the policies, and I am concerned that if you adopt deflationary policies in a period of deflation, then I would need someone to explain to me where the recovery comes from. That is my only point.

Senator **QUAYLE**. I do not think we are going to have a recovery until we do something about these deficits. I yield back my time to the Senator.

Senator **EXON**. Thank you, Senator Quayle.

I know you have to leave. I will come back to the agricultural question in a moment.

I guess I am somewhat concerned about the possibility of delaying the upcoming July tax increase in the face of the recession. Do you think that might be a wrong step?

Dr. **ROBERTS**. To delay it now, this year, yes, sir. I think that would be a wrong step.

Senator **EXON**. Thank you, Dr. Roberts. We understand you are on a tight schedule.

Dr. **ROBERTS**. Thank you, Senator.

Senator **EXON**. What do you have to say about that, Dr. Rutledge?

WHOLESALE FAILURE OF SPENDING CUTS

Dr. **RUTLEDGE**. I think the problem that you are talking about is the wholesale failure of spending cuts. The spending cuts proposed in the budget are nowhere near big enough. The budget overrun is the problem. It is not the tax side per se, but nevertheless, you cannot continue funding and spending without collecting taxes to do it.

So somebody in this great place has got to make up their minds how much money we have to spend, and once they make up their mind about that, they have got to collect that money through taxes.

So I think the budget proposals that I have seen attached to the chairman's name, to Mr. Boschwitz' name and others, make a lot more sense to me than the one the administration has put up right now. They do a lot more on the spending side.

If you try and try and fail, then you have to balance the budget with taxes. Borrowing is not a decent way to raise Government revenues.

Senator EXON. So if I understand the answer to my question, you are more concerned about the deficit and a high interest rate than to the direction we are going. You are not so much concerned—given the other concerns that you have, you do not think that might have a seriously deteriorating effect on the economy if we should delay or set aside or eliminate the upcoming July tax, do you?

Dr. RUTLEDGE. I think any serious action to get the budget plan set for the next few years in and of itself together with some deficit control measures would help the economy to recover. It would not slow it down. I expect the economy to drag on until early 1983 before we are seriously recovered.

My deficit worries are somewhat bigger than the ones the administration is talking about.

Senator EXON. Let me try once more. Assume that we accept the President's budget recommendations just the way they are with all the variables that we have, would you think we should—in the face of that, should we delay or eliminate the upcoming July tax cut or would you leave it in place?

Dr. RUTLEDGE. You should do things to raise more revenues. It is your choice about who you tax, but basically you need more money than your current taxes.

Senator EXON. Thank you.

Dr. Son?

Dr. SON. A couple of points that I want to make is that I know Dr. Roberts has said that. The Treasury Secretary Regan has said that. Really discovered that it is not all that bad. Do not get excited. The reason is if you look at the deficit as a percent of GNP it really is not all that high. In fact, it is lower than what it used to be.

U.S. GOVERNMENT HAS NO CREDIBILITY

Look at Japan, look at Germany. It is much higher. But I think we are really missing the point. The point is not whether it is a $50 billion, $150 billion. We are not talking about really the dollar figure. That is not as important as the credibility.

Now, if you talk about the financial markets, people are saying there, "Look, we have been promised the rose garden a thousand times and every time we have not seen it. We have not even seen a rock garden." So that really there is not credibility at all. [Laughter.] And that is what the issue is.

The reason why they can run such a high deficit as a percent of GNP in Japan is because the Government has a credibility. I wish we did here in this country, but we simply do not. To me that is the issue.

As to whether I would recommend postponing the tax cut starting this July 1, I recognize that this is not popular. I recognize that this may not even be practical, but if I were in your position, I would certainly vote for postponing the tax cut, because ultimately we are all supply-siders. We want lower taxes. We want more jobs, and to do that, I think we want to do the things the right way, and the way we are going about doing this today is really not right; that is, we are doing it backward.

In fact, this is not the first time that we tried this kind of an approach. If you look at the American economic history, back in the 1920's, we tried something very similar except that we did it right, and that is why it was called the golden twenties.

We cut Government spending, and when we could afford the tax cut, we cut the taxes. And that is why it worked.

Senator **Exon**. Thank you. When we start talking about cutting expenditures and I think there was some reference made to it in the sum of your statements about the defense budget, I would just simply say that there are rather significant things happening in the Armed Services Committee on which I served yesterday.

The Armed Services Committee stuck exactly with the figure as recommended by the President on a very lopsided vote. I did not support it, but it was a lopsided vote in favor of sticking with it.

So, therefore, I say that unless we can make some reasonable cuts not of the magnitude that I think they should be made in the chairman's suggested mark or Senator Hollings' suggested mark or even Senator Boschwitz' suggested mark, but unless we can make some reductions in that defense budget, then I feel that we have little chance of giving any kind of a total spending reduction in the Congress.

Senator **Quayle**. Would the Senator yield on that point?

Senator **Exon**. Yes. I think I have used up my time. I will wait for second round. So I yield.

VOTE NOT ACTUAL RECOMMENDATION

Senator **Quayle**. I just wanted to add that the Senate Armed Services Committee, though it recommended the President's budget figures, many Members voted just to pass along that figure with caveats. I was one of them, saying that recommending the President's budget figure to the Budget Committee was not an actual endorsement. There were other Senators that also said that.

So I think the report in the paper this morning that it was sort of overwhelmingly accepted by the Armed Services Committee can be very well misinterpreted even by members of the Armed Services Committee that voted just to more or less pass it along as a basis for discussion.

Senator **Exon**. Well, if the Senator would yield, I would just respond by saying that while I generally agree with the statements that the Senator from Indiana has made, the only way that I could term what the Armed Services Committee did yesterday then was a copout, because if we on the Armed Services Committee do not have the courage to stand up and say how much we should cut the budget and where, then we are not taking a practical approach, it seems to me, with regard to the Budget Committee who lacks the basic expertise that is needed in this area.

Senator QUAYLE. Well, I would say that the Senator has, along with me, said that there are going to be defense cuts, but I certainly am not prepared at this particular time to come along and say this, this, and this needs to be cut.

Now, maybe the Senator from Nebraska is and ought to put it on the table and we ought to discuss it. I think that the process that we are going through in the Budget Committee to determine how many resources that defense will spend is a proper process.

Chairman DOMENICI. Do not give us your ideas now.

Senator EXON. The chairman does not want me to give it to you now. [Laughter.]

ROBERTS WAS CORRECT

Chairman DOMENICI. I want to say for the record, and I did not find the time to put it in the record. Dr. Roberts was correct. In the February 18 program for economic recovery on page 23, the statement is there. "To that end, the economic scenario assumes that the growth rates of money and credit are steadily reduced from the 1980 levels to one-half of those levels by 1986."

So it was a matter of record. I would stand by the statement that that was not pushed hard up here. The appearance of Secretary Sprinkle on October 20, the one I referred to, at which time he had no serious criticism of the Federal Reserve in terms of their money policy.

Gentlemen, we are going to have to go to the next panel. I am very pleased that you joined us. Thank you very much for what you contributed.

The next panel is Dr. Rudolph Penner, director of fiscal policy at the American Enterprise Institute. Dr. Leonard Santow, the senior vice president and economist for J. Henry Schroder Bank and Trust. Dr. Charles Schultze, senior fellow at Brookings.

Let the record show that Dr. James Capra, Director of Fiscal Analysis for the Federal Reserve was invited. He prefers to submit his testimony in writing. Therefore, his testimony will be accepted and made a part of the record.[1]

Let us start in the order that I called you. Dr. Penner, you are first. We are now approaching 5 minutes of 11. I think you want to have a chance to talk to us so I would submit that not very many of us will stay very long after 12:15 so if you will adjust your opening remarks to meet that, Dr. Penner, you are first.

STATEMENT OF RUDOLPH G. PENNER, DIRECTOR, FISCAL POLICY STUDIES, AMERICAN ENTERPRISE INSTITUTE

Dr. PENNER. Thank you very much, Mr. Chairman. I will try to briefly summarize my testimony. The first part of that testimony attempts to define the problem as it must be confronted by the Congress. Because of problems with the administration's economic and noneconomic assumptions, I base my entire analysis on the CBO's base line estimates.

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[1] See p. 493.

ADJUSTMENTS TO ESTIMATES

I make three adjustments to those estimates. First, I add the administration's defense program. Second, I subtract any inflation adjustment to nonindexed programs because I do not believe that the Congress typically assumes that those programs have to be kept constant in real terms.

Third, while the CBO's economic assumptions are much more reasonable that the administration's, I do believe that they are still slightly optimistic. I think that if the Federal Reserve Board does adhere to its enunciated policy, the rate of growth of money incomes and tax receipts will be a bit slower over time than CBO assumes. Indeed my whole testimony and my whole analysis assumes that the monetary policy remains restrictive.

Chairman DOMENICI. Dr. Penner, I did not understand your second deviation. Would you explain it, please?

Dr. PENNER. Well, the CBO uses what they call the current policy concept, and that means that they assume that all programs in the Government are adjusted for inflation even if that is not required by the law. I simply reduce my estimates by the inflation adjustment that CBO applies to nonindexed, nondefense programs.

The horrendous results of my analysis are in my testimony. The estimates combine the off and on financing requirements of the Federal Government under my assumptions. What you see there is a steady and rapid increase in our financing requirements starting in the range of $100 to $150 billion in fiscal 1982 and rising to $225 to $275 billion by 1985.

DEFICIT RANGES INDICATOR OF DEPLORABLE STATE

As an aside, I might say that I never thought I would have to give $50 billion ranges for deficit estimates but I am afraid that is an indicator of the deplorable state we are in.

What should we do about this? Much of my testimony is devoted to generalizations regarding options for cutting spending and raising taxes. On the spending side, I begin with the unpleasant fact that defense plus social security plus the interest bill is about 60 percent of the 1982 budget and rising.

Therefore, it seems very clear to me it will be extraordinarily difficult to make any progress in slowing the spending path without examining those programs. On the other hand, it is not easy to cut those programs in the very short run. I believe our focus should be on the long run.

With regard to defense, I think I am as concerned as anybody that the readiness of our forces must be protected and therefore, I believe that cuts must focus on weapons procurement and military retirement. Such cuts do not have a very large effect on outlays in the short run, but do have a major impact in the long run.

But again, I emphasize as I will many times in this testimony that that problem is a long run problem. It is not the 1982 or even the 1983 deficit that greatly concerns me.

LIMITED BY MORAL CONTRACT

With regard to social security, I think the issues there are political in the best sense of the word political. We are, I think, limited by a moral contract with the beneficiaries. Therefore, cuts have to be gradual. They cannot be abrupt.

Indeed, I do not even like to refer to cuts. I think that you can solve a very large part of the problem simply by slowing down the rate of increase of spending and the rate of increase of real benefits promised by current law.

And in fact, while I referred to it as a moral contract, I think that contract can only be truly moral if it reflects the interests of not only the beneficiaries but the taxpaying workers as well, and I do not think it does now.

I do believe that all the risk is now on the side of the workers, and therefore, I think that the moral contract needs renegotiation. I do make a number of specific suggestions in my testimony which would have the effect of at least insuring that the beneficiaries would not do better than taxpaying workers for significant periods of time.

Again, I repeat that my emphasis is entirely on the long run. I think it is the long run that the financial markets are worried about. I think that if the Congress made any progress at all in reducing social security, our most difficult nondefense spending problem, that financial markets would, indeed, be impressed. I know I would be impressed if we could do something about this very difficult issue.

There are, of course, other nondefense, nonsocial security cuts which are quite rational and have been suggested by the CBO. I might add that the administration itself has made some good suggestions in their budget especially regarding medicaid and medicare, very difficult issues themselves.

I really hope that the bad estimates in many parts of the President's budget do not detract people's interest from the whole thing, because there are a lot of good suggestions for cuts in the President's budget as well as some dubious things.

WORK TOWARD CLOSING LOOPHOLES

On the receipts side, I enunciate certain basic considerations which should guide us in raising tax receipts in the ideal. If we can avoid it, I would prefer not to see a tax increase in 1982.

I am not much of a Keynesian. I am certainly not a supply-side economist, but I still would be somewhat concerned about any significant change in tax policy when the economy is in such a tenuous condition.

We have to focus on tax increases in 1983 and beyond, and there ideally—and I stress the word "ideally"—we should work toward base broadening, that is, closing loopholes, instead of increasing marginal tax rates which are the thing that affects economic incentives. My testimony gives some specific examples which satisfy that situation.

Again, in the ideal I would like to avoid base broadening which increases the rate of taxation of capital income; however, there is one very important exception to this rule. The depreciation law passed last year is extraordinarily generous.

If it goes through and we have the additional schedule steps in that law for 1985 and 1986 and if you accept the economic assumptions which underlines my analysis as to interest rates and inflation and so on, the tax rate on many types of equipment investment will actually be negative. There will be an actual subsidy. I think that goes too far, and I would eliminate the next two steps that are now scheduled.

For national security reasons, I do believe that there is a very good argument for taxing energy in this country more at this time when the world price of energy is going down. We remain vulnerable. I fear that the excellent progress we have made in conservation could be reversed if we have a temporary downturn in the price of energy. I think I would hold this view even if we did not have a deficit problem, but energy tax increases do happen to raise an enormous amount of revenue.

My last point is that I do believe in user fees wherever they can be applied practically in the Government, and the CBO has provided numerous uses for options.

SPEED IS ESSENTIAL

Having spent so much time on principles, let me return to the difficulty of the practical situation. The problem with my generalizations and principles is that they involve numerous legislative actions, each raising only a few billion dollars, and each creating an enormous political battle.

I believe that the difficulties we face are too serious to go through step-by-step process on the spending and tax side. Therefore, Mr. Chairman, I am very much drawn to a plan such as yours or Senator Hollings or Senator Boschwitz, that is to say, plans that propose somewhat arbitrary rules to guide cutting or freezing different types of spending.

It is a broad brush approach, and therefore, would, of course, involve some inefficiencies and inequities, but I do think that speed is essential, and we do not have the time to go through endless political debate over narrow issues.

A common feature of most of the generalized plans is some postponement of the personal tax cuts now scheduled. Such a postponement or rescinding them completely does violate my second principle that marginal rates should not be raised, but I will accept that violation in the interest of being pragmatic.

Why do I think it is so important to avoid the growing deficits that we see before us. I would suggest that deficits at this time are having four negative impacts on the economy and on the budget itself.

TRADITIONAL CROWDING OUT

First, there is the traditional crowding out that economists have talked about for a very long time. Usually, economists focus on the capital formation aspects of crowding out, but it should be noted that crowding out is a much more pervasive phenomenon than that.

If savings rise, consumer durable expenditures are likely to fall so you have a crowding out of things like the auto industry, the appliance industry, and maybe even some crowding out of ordinary consumption which is not necessarily bad if we wish to divert consumption to capital formation.

But what we have done goes so far that we have various industries like the auto industry in a completely deplorable state and would be likely to recover slowly if we continue to pursue a path involving growing deficits.

Some people say, "Maybe we can get some savings from foreigners which will reduce the crowding out of business capital formation in this country." That is theoretically correct. If we get foreign saving it will reduce crowding out, but the balance of payments must balance. So if we import capital, we have to run a current account deficit, and we do that by having a higher valued dollar so that crowding out gets pushed on to export- and import-competing industries.

INFLATIONARY EXPECTATIONS

The second negative effect of the deficit is on inflationary expectations. A deficit need not, in pure theory, be inflationary. It is important whether or not the Fed monetarizes that deficit.

In past history, a number of studies suggest that there has been a tendency for the Fed to do just that. The Fed says they will not this time. I, in fact, believe they will not this time, but I do not think you can say that they will not with 100 percent certainty, and I believe that even if there is a 10-percent chance that they go back on their promise, people who actually invest in dollar demoninated bonds find that risk sufficiently scary that they demand a hiqher risk premium on those bonds. In other words, a higher interest rate results than would result from the crowding out phenomenon alone.

ADJUSTMENT FROM LOW DEFICIT COUNTRY

The third negative effect is perhaps temporary but very important right now. We are undergoing an adjustment from a low deficit strategy—we have, indeed, been very responsible in the past compared to our European friends and the Japanese and so on—to a high deficit strategy.

This implies that we suddenly have to persuade investors to start swallowing huge amounts of Government debt compared to what they have been used to. It involves, therefore, a change in their investment habits, and perhaps even in some institutional rules.

Therefore, you might temporarily have a higher interest rate impact than you would have had if we had more slowly made the adjustment from a low to a high deficit country.

EFFECT ON INTEREST BILL

The last point I would make is that the deficit is having a very large effect on the interest bill on the debt. The interest bill itself is becoming a driving force in the outlay side of the budget.

I believe interest will be the most rapidly growing outlay function over the next few years. The increase in the interest bill between fiscal 1981 and fiscal 1983 will more than offset all of the cuts that the Congress made last summer.

My overall conclusion is that we face a very difficult problem. It creates a risk of driving us into a British type situation of stagnation and very high unemployment.

I believe that fast action is required, and therefore, we cannot spend too much time on all of the fine points as to how we cut spending and raise taxes. Indeed, I probably spent too much time on fine points already.

I thank you.

Chairman DOMENICI. Thank you.

PREPARED STATEMENT OF RUDOLPH G. PENNER, DIRECTOR, FISCAL POLICY STUDIES, AMERICAN ENTERPRISE INSTITUTE

I would like to thank the Committee for this opportunity to testify. The views expressed in this testimony are my own and do not necessarily reflect the views of the staff, advisory panels, officers or trustees of the American Enterprise Institute.

I shall base my analysis of the 1983 budget on Congressional Budget Office (CBO) documents which are more realistic in their economic assumptions than is the Administration and in their estimates of spending rates and program costs for any given economic outlook.

Adjusted baseline deficit

The CBO begins the analysis by projecting spending commitments and the tax laws as they existed at the end of 1981. Their analysis assumes that all programs are adjusted for inflation, including those that are not explicitly indexed.

To view the problem as it must be viewed by the Congress, I shall make three adjustments to CBO figures. First, the President's recommended defense program will be added to the outlay figures.

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[1] Views expressed in this testimony are those of the author and do not necessarily reflect views of the staff, advisory panel, officers or trustees of AEI.

Second, inflation-adjustments to non-indexed non-defense programs will be subtracted. I do not believe that the Congress has ever presumed that such programs must be held constant in real terms. After these two adjustments the budget projections through fiscal 1985 are as follows:

FISCAL YEARS

(billions of dollars)

	1981 actual	1982	1983	1984	1985
Outlays	660	740	806	885	972
Receipts	603	631	652	701	763
Unified deficit	58	109	154	184	209
Off-budget deficit	21	20	19	18	18
Total deficit	79	129	173	202	227

While the CBO economic assumptions are more reasonable than the administration's, they do assume a rather high rate of nominal income growth if the Federal Reserve System carries out its enunciated monetary policy and gradually slows the rate of growth of the money aggregates. For example, if the top end of the Fed's target range for M-1 growth of 5.5 percent for 1982 is lowered by one-half of one percentage point per year and if the amount of economic activity that can be financed by a given money supply continues to grow at the same rate experienced since 1970, the nominal GNP in 1985 would have to be lowered by slightly over 5 percent. If all of that reduction was the result of lower inflation, the 1985 deficit would have to be increased by about $15 billion. To the extent that real growth is also slower than assumed by CBO, the deficit increase would be larger.

I shall not attempt to make a precise adjustment for the relatively small change in economic assumptions suggested by the above analysis, but will instead use the following ranges for the horrendous on-plus off-budget deficit problem faced by the Congress.

FISCAL YEAR	ON PLUS OFF-BUDGET DEFICIT RANGE
1982	$100 - $150 billion
1983	150 - 200 billion
1984	200 - 250 billion
1985	225 - 275 billion

It should be re-emphasized that these estimates depend crucially on the assumptions regarding monetary policy. Monetary policy and fiscal policy are intimately entwined. Inflation can be used to raise tax burdens and to reduce deficits. That will be true even if personal tax brackets are indexed after 1984, but, of course, much less true than it is today.

Options for Cutting Outlays

The size of the future deficit problem suggests that the Congress will have to alter the old saw, "tax, tax, tax and spend, spend, spend," to "tax, tax, tax, and cut, cut, cut."

This short paper cannot explore all of the possible options for taxing and cutting, but will have to confine itself to discussing a few main points and basic principles. When confronting the spending side of the budget, it is necessary to begin with the unpleasant fact that defense, social security (OASDI), and net interest outlays will comprise almost 60 percent of the 1982 budget. Without some reduction in defense and social security growth, prospects for controlling total spending in the long-run look bleak. Unfortunately, in both cases, large immediate reductions would be either unwise or unfair. But the emphasis must be on the long-run because the deficit is now a long-run problem.

With regard to defense, it is necessary to be cautious about compromising the readiness of our forces. Savings should be focused on long-run weapons procurement and military retirement pay. The CBO has suggested eleven options for defense cuts, all of which appear reasonable. For example, the B-1 program would be scrapped in favor of the advance technology bomber. Naval forces would be deployed somewhat differently than envisioned by the Administration and production runs of the M-1 tank would be limited in favor of the much less expensive M60A3. Retirement pay would be restructured in a number of ways to compensate for overindexing in the past. Admittedly, the savings from the CBO options are negligible in 1983 and 1984 but rise to $10 billion in 1985 and $15 billion by 1987. Perhaps more dramatic cuts could be found, but the modesty of the CBO suggestions is, at least, interesting in an area where many believe that cuts could resolve a high proportion of the deficit problem.

Social Security presents an enormous challenge to our political system. It is an extremely popular program and the smallest change in the benefit structure is perceived to be a threat to the entire system by the program's multitude of constituents. Yet, because of the system's huge size, even small reductions in its growth rate would save massive amounts in the long-run. Moreover, it is hard to justify holding social security benefits sacrosanct when the recipients have recently been faring better than the average worker and we have been significantly cutting other less affluent recipients of government transfers.

One change which may be saleable politically would be to index benefits to the lower of wage or price increases. I do not believe that the population thinks it fair for social security recipients to do better than wage earners. It could be understood that if this technique caused a significant shrinkage in real benefits over the long run, there would be periodic upward discretionary adjustments in benefits. If the same principle were applied to the indexing of the formula determining future benefits (the formula is now linked to wage growth), large amounts could be saved in the long-run. Again, it must be emphasized that it is the long-run which counts. It is not short-run deficits which are scaring financial markets. It is the fear that they will continue to rise for the forseeable future that is so troublesome. If some signal could be given that social security, the most important component of the non-defense outlay growth problem, was being controlled, it would, in my view, have a significant impact on expectations.

The precise savings implied by the above options depends on the relationship between wages and prices which has been erratic in the recent past. If the system had been in effect between 1975 and 1981, the savings in the latter year would have been $10 billion, largely because of a significant fall in real wages in 1980.

Other indexing options have been suggested and are reasonable given that recent cost-of-living adjustments have been excessive due to upward biases in the CPI. Martin Feldstein has suggested that cost-of-living adjustments compensate for only that inflation in excess of 2 percent per year. Given CBO inflation assumptions this option would save $10 - 15 billion in 1985. Others have suggested delaying the cost-of-living adjustment to September 1. That would save over $3 billion in 1985. The savings would expand significantly if the same options were used in all of the other indexed programs of the government.

The suggestions made above imply that relatively minor changes in social security indexing might save $15 billion or more by 1985. To provide some notion of the enormous size of social security relative to other transfer programs, it can be noted that $15 billion in 1985 will be sufficient to finance the entire food stamp program.

The CBO has outlined options for over $25 billion in cuts of non-defense, non-social security programs. All deserve serious consideration. The Administration has suggested further efficiencies in medicare and medicaid which are also worthy of note because without some economizing these two programs will grow by about 14 percent per year between 1981 and 1985. The Administration has also suggested numerous reasonable options for cutting housing assistance and other programs. It would be a shame if the admittedly serious estimating problems within the President's budget prevented any of it from being taken seriously.

There is, however, one category of Administration cuts which should be rejected. The Reconciliation Act of 1981 concentrated its welfare cuts on the working poor. Many of the Administration's 1983 proposals in the welfare programs would go further in this direction by increasing the rate at which benefits fall as earnings rise. The end result is little incentive for one to work oneself off welfare. The Administration would substitute regulations requiring work for economic incentives. Such regulations have not been effective in the past, and it can be noted that in all other areas of policy the Administration has emphasized increased economic incentives and reduced regulation.

While there is no shortage of options for cutting defense, social security, and other spending, it is difficult, given political and time restraints, to imagine cutting more than $50 billion from 1985 outlays by examining the options one at a time. It would take an effort comparable to that enacted in the Reconciliation Act of last year, and that seems implausible two years in a row.

Because a $50 billion cut would leave a 1985 deficit in the range of $200 billion given my economic assumptions, more extreme action is desirable. Such extreme action generally involves a set of arbitrary cutting rules.

Senator Domenici, Hollings, and others have suggested various combinations of generalized rules and freezes which have considerable appeal. While it must be admitted that any general rule is bound to create numerous inequities and inefficiencies, a generalized approach may be the only practical way to make a severe dent in the strong upward trend in spending which was barely affected by the strong measures of last year.

If all that is possible on the outlay side is $50 billion or less in cuts, it is my judgment that about $100 billion in receipts increases are required to start bringing the deficit down to tolerable levels by 1985. By tolerable levels, I mean something in the range of $100 billion. Obviously, even this is nothing to brag about and a lower deficit would be preferable, but unless some action on the outlay side more dramatic than anything undertaken in past history occurs, I see no way of getting there from here which does not involve extremely disruptive tax increases.

Again, all of this assumes that the Fed adheres to its targets. While inflation can be used both as an implicit tax and as a means of raising explicit taxes, most observers would agree that inflation is the worst possible approach to deficit reduction.

Options for Increasing Receipts

If we are embarking on a path involving $100 billion in extra revenue, it would be desirable, in the ideal, to follow certain basic principles in raising that much money. First, if it can be avoided, there should be no tax increase in calendar 1982. The economy is in a tenuous position and significant tax increases this year increase the risk that the recession will deepen and that the initial stages of the recovery will be sluggish.

Second, increases in the tax burden should take the form of broadening the tax base instead of raising marginal tax rates. Moreover, base broadening measures should be aimed at enhancing economic efficiency. Some examples of such base broadening efficient measures are as follows: Tax employer paid health insurance to reduce the incentive to buy inefficient insurance (raises $6 billion in 1985). Eliminate the interest deduction on consumer loans other than mortgages ($8 billion in 1985). Tax workman's compensation and unemployment insurance to reduce the work disincentives inherent in those programs ($6 billion in 1985). Other examples can be found in the CBO report on Reducing the Deficit.

Third, base broadening measures should avoid increasing the tax on capital income. There is one important exception to this rule. The depreciation law passed last year becomes very much more generous in two steps scheduled for 1985 and 1986. Given the inflation and interest rate assumptions inherent in this analysis, the tax burden on new equipment investments will become negative, i.e., the tax system will provide outright subsidies for investing. This goes too far. Those two steps should be eliminated unless inflation and interest rates rise above current levels. That would raise about $2 billion in fiscal 1985, $10 billion in fiscal 1986, and $20 billion in fiscal 1987.

Fourth, there are good, long-term national security reasons for increasing the taxation of the consumption of energy in this country. In particular, recent weaknesses in the price of oil may dampen our conservation efforts and should be countered. This could be accomplished with a tax on imported oil which aimed at eliminating reductions in the real price of oil. If nominal prices remain constant, a tariff of about $5 per barrel could be justified in 1985. This would bring in about $17 billion including its impact on windfall profit tax receipts. Alternatively, raising the gasoline tax to 10 cents per gallon would raise about $5 billion by 1985.

Fifth, whenever practical, user fees should be charged to the beneficiaries of government goods and services. CBO suggests options which would raise $6 billion by 1985.

Although the principles suggested above could be used to raise large amounts of revenue by 1985, the step-by-step approach on the tax side faces the same practical problems as the step-by-step approach on the spending side. A score of legislative changes would be required and each would involve an enormous political battle over a few billion. Since there is a pressing need for more receipts and quick action is required, it may be necessary to eliminate the 10 percent tax cut in personal income taxes scheduled for July 1, 1983 and to delay indexing one year. This violates my second principle that marginal rate increases be avoided. But only one political battle would be required and if successful, it would raise $52 billion by 1985.

It may be time to begin a debate on a brand new tax such as a value added tax or a national sales tax. Every rate point would raise $10 to $15 billion if the base was kept fairly broad.

I would prefer to avoid such a tax, since once implemented, it would be too easy to increase. However, absent a drastic reduction in the deficit following the outlay cutting and receipts raising approaches discussed above, a new broad based tax may be essential.

The Impact of Deficits

Why is it so important to reduce the deficit? Even if deficits approach $250 billion in 1985, that will only amount to about 6 percent of the GNP and other countries have continued to grow and have controlled inflation while running such deficits.

In my view a deficit of that size has four negative impacts. First, there is the traditional crowding out effect. Usually, it is discussed as though the only important crowding out involves business capital investment. It is said further that that will be mitigated by increased personal savings inspired by the tax cut and by an inflow of foreign saving. However, things are not quite that simple. First, the prospective deficits are very large relative to personal saving. Personal saving was only $100 billion in fiscal 1981. It may be increased greatly by the tax cut, but it will also be increased by the deficit itself as higher interest rates crowd out consumption, especially spending on interest-sensitive durables such as autos.

In other words, crowding out is a widespread phenomenon and does not only affect capital formation.

For example, inflows of foreign saving will require the development of a current account deficit since the balance of payments has to balance.

This will be accomplished by bidding up the value of the dollar which will crowd out export and import competing industries. Again autos get clobbered. Housing is also very sensitive to crowding out and the recovery of that sick industry will also be delayed by larger deficits.

In any case, it will be a close race to see whether personal saving catches up with the deficit. If they remain approximately equal, it means that all capital formation must be financed using business saving which, while increased by the tax cut, is being hurt by low profits during the recession; state and local saving, which will be hurt by the recession and major cuts in grants; and foreign saving which has the negative impacts discussed before.

The second negative effect of the deficit involves inflationary expectations. Deficits are not inflationary unless the Federal Reserve System buys Treasury bonds by creating new money. This is called monetizing the debt. There is no technical need to monetize, but the political pressures to do so are enormous as people complain about the high interest rates caused by the deficits. In fact, several empirical studies suggest that money creation has tended to accelerate in the past whenever deficits rise. Even if investors believe that there is only a small chance of that happening in the near future, the results of monetization would be so devastating that investors increase the risk premium demanded on loans. Thus real interest rates may be raised by more than the amount which would result from the crowding out effect working alone.

Third, there are adjustment problems involved in suddenly adjusting to a high deficit strategy. In part, we shall suffer some costs because we have been a relatively low deficit country in the past. Suddenly, investors must be persuaded to increase their holdings of government debt at a much higher rate than was experienced in the past. Investor habits and perhaps some institutions will have to be changed. For example, imagine that we can hold debt creation to the $150 billion per year level in the period 1983 through 1985. The Fed would have to buy about $8 billion per year to implement their targets. Debt in the hands of private investors would have to rise at 16 percent per year or about 8 1/2 percent in real terms given CBO inflation assumptions. Nothing approaching this rate of increase has occurred since World War II. The previous high occurred in the '72-'76 period when the nominal debt rose at 11 percent per year or about 4 percent in real terms. Persuading investors to begin absorbing this much debt suddenly may take a larger rise in interest rates than if they had been absorbing it at such levels over a long period.

The last impact of the deficit involves the interest bill itself. With high deficits it becomes a driving force on the outlay side of the budget. Net interest will already constitute 12 - 13 percent of outlays in 1983 compared to about 7 percent ten years earlier. The increase in the interest bill between 1981 and 1983 will far exceed all of the budget cuts occurring in 1981. Interest payments may not have the same negative impact on the economy as other governemnt spending but they do have to be financed and they can be expected to keep growing.

Conclusion

We face an extraordinarily difficult situation. The long-run tax cuts of last summer mortgaged our future because they were not countered by sufficient budget cuts. The prospect of huge deficits is causing much uncertainty which, in my view, is delaying recovery from the current recession. It is important quickly to show some resolve in reducing the deficit. At this point, we should not waste much time debating the fine points about exactly the right kind of spending cut or tax increases. Speed is important because there is a considerable risk of entering a British type recession if interest rates are not brought down quickly. The recent substantial fall in long rates is reassuring. A more sensible fiscal policy would help greatly to maintain and extend that decline thus increasing the chances of a healthy economic recovery beginning before mid-year. If we wait to see more economic data before taking unpleasant actions that data itself may be very unpleasant.

Chairman DOMENICI. Dr. Santow.

STATEMENT OF LEONARD JAY SANTOW, SENIOR VICE PRESIDENT AND ECONOMIST, J. HENRY SCHRODER BANK & TRUST CO.

Dr. SANTOW. I have a statement that is approximately three-quarters of one page, and so I think I will read it, and then I will spend about 5 minutes or so explaining some of the details behind and reasoning behind the statement.

METHODS FOR REDUCING BUDGET DEFICIT

My objectives are simple and straightforward. They are to define politically palatable methods of substantially reducing the budget deficit and the financing pains associated therewith. The program proposed has four parts. One is to limit Government and social security cost-of-living adjustments. Two is is to impose an oil import tax with a new twist. Three is to impose a windfall profits tax on natural gas also with a new twist and four is to use special savings inducements to attract funds available from the two upcoming 10-percent income tax reductions.

Point No. 1, Government and social security cost-of-living adjustment clauses would work in the following way:

(*a*) On July 1, 1982, a 4-percent COLA adjustment would be paid.

(*b*) On January 1, 1983, an additional 4-percent COLA adjustment would be paid.

(*c*) From then on the COLA adjustments will occur annually at the beginning of each calendar year and will always be a minimum of 4 percent plus half of the amount over this 4 percent based on the previous year's increase in the CPI.

(*d*) The CPI increase for a year would be based upon a fourth quarter average to a fourth quarter average.

(*e*) Thus at the beginning of calendar 1983, if the CPI advanced by 8 percent from the average of the fourth quarter of 1981 to the average of the fourth quarter of 1982, the COLA at the beginning of 1983 would be 6 percent; that is, the base of 4 percent plus half of the other 4 percent.

Suggestion No. 2, an oil import surcharge tax would be passed with the funds obtained placed in a Department of Defense trust fund that will be used to help pay for the military cost of fuel.

Three, a temporary windfall profit tax will be placed on freed up price of natural gas. The proceeds of this tax will be placed in a trust fund for the benefit and use of State governments in what may prove to be a painful process in the move toward federalism. The tax would end and the proceeds all paid out to the States when the federalism program is fully in place.

Four, individuals would be allowed to take their 10-percent tax reductions this July and next and invest these amounts in their IRA or Keogh accounts above current limits or be allowed to buy a special issue of tax-free or limited tax Government savings bonds.

PRESIDENT HAS HEELS DUG IN

A little bit of background on some of the comments. No. 1, I am assuming that the President is not going to budge with respect to the income tax reductions on July 1. I think he has dug in his heels. Whether I would like to see it deferred or not, is immaterial. I am making the assumption therefore that these proposals have to be palatable to the administration.

PROLIFERATION OF PROPOSALS SELF-DEFEATING

The second point which is important is that because of the time element involved—you have got a problem with so many people in Congress having come up with their own individual proposals. I think it is terribly important that Congress get behind one proposal and get it through in order to get the deficit down.

I think that a proliferation of proposals at this time is self-defeating, even though many of the points in the different proposals are highly worthwhile.

MAKING PRESIDENT'S PROGRAM MORE PALATABLE

The third factor, I think, that is important—is what I tried to do—is to take the tax or revenue enhancements and tie them to part of the President's programs in order to make them more palatable to the administration. For example, funds going into the Department of Defense; funds going toward federalism and helping out the State and local governments; funds going into savings to help finance the deficit. You can come up with, I am sure, an enlarged list, and you can modify some of these things. For example, there is nothing magical about using a 4-percent number on the COLA adjustment. I could have used 3 percent. I could have used 4 percent. If the number is below 4 percent, the recipients, in a sense, win. In other words, if the CPI comes in at 2 or 3 percent, the recipients would do better than inflation. Anything over 4 percent, they would do worse.

One slight technical problem I will mention to you is that the COLA base will not be completely available when you pay out the increase. I tried to limit the problem by using the average of a fourth quarter to the average of a fourth quarter. For example, in January 1983 when you made your first COLA payment, you would not have the December number for 1982. That is why I attempted to use the fourth quarter to a fourth quarter measurement to minimize that problem.

OPTIONS VERY ATTRACTIVE

On the fourth point which is the 10-percent tax reduction, I think it would be very attractive to many Americans to save this amount in a tax-deferred way or to be able to buy Government securities that would give them a special tax break. Otherwise, most of this money, I think, is going to be spent and very little of it saved. Since the supply-siders want to get the economy moving by having increased savings and increased investment, it seems to me this approach would do that.

As far as my budget estimates are concerned, just to give you some background, in the first quarter of the current fiscal year, which is October through December, the deficit based on the way I worked out the numbers was running at $60 to $70 billion.

In the January–March quarter, which is the one we are currently in, the annualized deficit was running at about $70 to $80 billion. So in the first half of the current fiscal year you are running at about a $70 billion deficit.

Then you start to get the refunds in March, April, and May which we estimate to be $7 to $8 billion higher than they were a year ago, and the deficit on an annualized basis in the April to June quarter moves up to a $90 to $100 billion annual rate. After that, you get the 10-percent tax reduction and the 8-percent social security payment and the other cost-of-living adjustments. So by the fourth quarter of the fiscal year, July through September, you are running at $120 to $130 billion annual deficit.

From a fiscal stimulation point of view, which I view in terms of the change in the size of the deficit, the big stimulation basically comes from March when the refunds start to pick up through August–September. That is when you get your big push. After that, the push moderates substantially. Thank you.

Chairman **Domenici**. Thank you.

Dr. Schultze.

STATEMENT OF CHARLES L. SCHULTZE, SENIOR FELLOW, BROOKINGS INSTITUTION

Dr. **Schultze**. Thank you, Mr. Chairman. I have an unconscionably long statement which I will ask to go in the record, and I will summarize it.

Chairman **Domenici**. It will be made a part of the record.[1]

BUDGET ACTIONS FACE FOUR QUESTIONS

Dr. **Schultze**. Mr. Chairman, it seems to me there are four questions you are facing in getting at this year's budget actions and what you ought to do. The first question, and I want to offer a few comments on each of them, is how large is the budget deficit likely to be in the absence of further actions to reduce it, that is, how big is the problem in front of you.

Second question: How important is it to lower the deficit? Is deficit reduction alone an answer to the country's economic problems? Should a large reduction in the deficit be accompanied by an easing of monetary policy?

Third question: Can the deficit be reduced sufficiently by the administration's proposed approach of small tax increases, exempting defense and social security from cuts and concentrating the spending deductions in the remainder of the budget?

Fourth question: What are the alternatives—the major alternatives—for making large reductions in the deficit?

It turns out that my estimates of what the deficit is likely to be before you take any action are not very different from Rudy Penner's, and since he has presented them, I will simply refer you to my testimony. As you can see, they are pretty much in the middle of his range of numbers. I will not elaborate. I got to it in a slightly different way.

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[1] See p. 451.

Basically what it means is that by 1985, well, by 1983, you would have a deficit equal almost to 5 percent of GNP. You have about $165 billion, and by 1985, with no actions in the administration's defense program, the deficit would balloon to $230 billion or 5½ percent of GNP. Obviously, deficits of this size have to be reduced.

I might remind you that in the worst year of the Vietnam war when we were trying to finance both the Great Society programs and the Vietnam war without a tax increase, the deficit was 2 percent of GNP. You may recall the results of that effort. I painfully do.

DEFICIT REDUCTIONS ALONE NOT ENOUGH

But deficit reductions alone are not enough in my judgment. The Federal Reserve is now engaged on a course of monetary policy that is unprecedented in its tightness. If, under these circumstances, budget deficits rise to the unprecedented heights that are in the table, the level of real interest rates is going to remain intolerably high and perhaps increase over time, causing extremely severe consequences for the interest sensitive sectors of our economy.

Yet the tax increases and spending cuts needed to give a truly large reduction in the deficit will tend to dampen the growth of demand and spending in other areas of the economy, consumption and defense industries—just at a time when the Federal Reserve is heavily restricting economic growth.

The combined degree of economic restraint from both fiscal and monetary policy may then be unnecessarily severe.

So this line of reasoning suggests that if truly large deficit reductions can be made, and I think they ought to be, they should be accompanied by some cautious relaxation in the present course of the monetary policy.

Let me look at this further by pointing out that there are really two different aspects of deficit reductions in terms of their impact on the economy. In the first place, borrowing to finance deficits obviously reduces funds available for private investment.

Reducing the deficit, therefore, frees up private savings to support private investment. Another way to put it is that the tax increases and spending cuts that lower the deficit tend to reduce expenditures by consumers and government leaving more labor, capital, and raw material resources to produce factories, machinery and housing.

Thus, reducing the deficit increases the real and the financial resources available for private investment, but there is another aspect. While a cut in the deficit increases resources available for investment, it does not itself generate that investment.

Raising taxes and cutting expenditures in order to lower the deficit cuts production of consumer goods and goods for Government. That cut in the deficit will lead to somewhat lower interest rates, but there are no economic models that suggest the decline in interest rates will be enough to generate the requisite increase in investments to offset the declines in consumption and government spending.

DEFICIT REDUCTION WILL LOWER EXPENDITURES AND GNP

Taken by itself, therefore, a deficit reduction will lower both national expenditures and GNP while at the same time making more room available for private investment.

In turn, I think two different sets of considerations are relevant in determining the appropriate size of the deficit. One, lowering the deficit can change the composition of GNP. Out of a given GNP, a larger share becomes available for investment. Reducing the deficit with no offsetting change in monetary policy will lower the level of demand in GNP from what it otherwise would have been.

To the extent that the Government wants to place additional restraints on economic growth and employment, then this type of deficit reduction is a good idea. But to the extent that only a change in the composition of GNP is desired, then a large deficit reduction, at least in my judgment, should be accompanied by an easing of monetary policy.

COMPOSITION OF GNP

Let me turn to the first question: The composition of GNP. I would ask you to take a look at my testimony. There I have tried to summarize postwar trends in saving in the economy as a percent of GNP and how that savings has been used, and then project it out to 1985 on two assumptions. One, you do not do anything to lower the potential budget deficit, and two, you cut $150 billion out of that deficit, bringing it down from $230 to $80. That is kind of a ballpark number.

FEDERAL DEFICIT ABSORBED MOST SAVINGS

If you look at the table, you can see that savings modestly increased over the postwar period in the United States. I am using 10-year averages down in the bottom column where it says, "Uses of Savings." Most of that increase in savings was absorbed financing the growing Federal deficit, leaving some but not very much room for an increase in private investment.

Now, go out to 1985 on the assumption of no reductions in the budget. You are running a $230 billion deficit, 5½ percent of GNP. Allowing for a very generous increase in private saving from the tax cut, you still, nevertheless, cut the amount available for private investment down to way below other postwar averages, and if you remember a lot of business investment to replace existing plant and equipment, you leave, although I have not done the calculation, virtually no room for any kind of productivity improvement and expansion in our capital stock.

Even if you cut $150 billion out of the deficit, you end up, at least on these estimates, of restoring the situation and making room for a modest improvement in the amount of funds available for private investment.

Hence, a budget reduction of $100 to $150 billion is needed, in order to allow room for adequate private investment.

COMPOSITION OF GNP AND AVAILABILITY FOR INVESTMENT

Next, let me turn to the second question. This has to do with the composition of GNP and how much is available for investment. What about the level of GNP? What about the growth of the overall economy, forgetting its compostion for the moment?

Given the current trend in restrictive monetary policy, a $230 billion current policy deficit by 1985 would provide a major collision, almost an explosion in the economy. Explosion is probably too strong, but a major collision.

On the one hand, the deficit, because of the tax cuts and the increase in defense spending, will be pumping up consumption in the defense industry. Tight money, keeping interest rates at or near the recent unprecedented level for the foreseeable future, is going to keep the housing, auto, and other interest sensitive industries in a continuing depression.

You would have a highly erratic economy, a highly unbalanced economy, and the potential of serious damage, in the financial structure of business both financial and nonfinancial business, possibly leading to a much more serious and long-lasting recession somewhere in the near future. That deficit has to be reduced on those grounds.

Reduction of the deficit by some $150 billion to about 2 percent or less of GNP would ease these problems, but the large tax increases and cuts in Government spending needed to cut the deficit this much, combined with a continued tight money policy by the Fed, would, in my judgment lead to somewhat lower interest rates but would also lead to a world of sluggish growth in which the unemployment rate would not decline much below 8½ percent over the next 3 to 4 years.

Now, while we do need restraint on the economy—we do not want to grow too fast because we are trying to pull inflation down—the above-mentioned policy that is more rigorous than necessary.

EASE MONETARY POLICY

And so, to come to a conclusion on this part, while we do need a large deficit reduction, we need simultaneously a cautiously easier monetary policy. I guess I stress both words, easier and cautiously.

Once a credible deficit reduction of actions are underway, the Fed can and should take positive action of a moderate amount to ease monetary policy. The growth in the money supply can then be raised.

A large part of the second half of my testimony, Mr. Chairman, goes into looking at ways to cut the deficit. You might want to look at it, but it stresses one theme.

For economic, social and above all political reasons, we need to put together a package that will cut the deficit by 1985 some $150 billion. Actually, if you can cut the deficit by about $125 by 1985 and amounts leading up to that in the meantime, you reduce national debt and the lower payments on interest will get you the last $25 billion. You get kind of a bonus whenever you cut the budget.

So what you really need is $125 billion of action. To get a package that big, however, it is going to require across-the-board action, in particular, it cannot be done as the administration proposes by exempting defense and social security and forgoing any general tax increase.

The remainder of the budget simply is not large enough to support the needed cuts. Only if all segments and society share in the burdens of budget reduction can it get done.

PACKAGE FACES SEVERE PROBLEMS

But let me conclude, Mr. Chairman, by noting there are several severe problems in putting this package together, the necessary comprehensive budget action and some monetary actions as well.

Let me cite two of those problems and suggest again very, very tentatively that they can be overcome. In recent years, it has become commonplace for high Government officials many financial executives, and some prominent economists to equate the successful reduction of inflation solely with success in achieving a steady reduction in the growth of the money supply.

The toughness and credibility of the Federal Reserve has come to be judged by a large number of vocal and influencial critics in terms of how firmly the Fed refrains from raising its monetary targets in the face of growing strains and how successful it is in meeting those targets.

Hence, the Federal Reserve probably faces and certainly believes it faces the problem of worsened expectation in the event that it proceeded either to raise its targets for money growth or to overrun the existing ones.

It is widely believed that participants in financial markets would interpret such action as the weakening of anti-inflationary resolve and, as a consequence, long-term interest rates might rise rather than fall.

A quite different problem arises for the Congress in trying to put in place an integrated approach which substantially reduces the deficit while moderately increasing monetary benefits.

FOUR PARTIES MUST COME TO AGREEMENT

There are four independent sets of actors who have to come into broad agreement to put such a policy together, the executive, the leadership of both parties in the Congress, and the Federal Reserve.

Without an explicit agreement or accord, each party is going to find it difficult to act for quite different reasons. If, for example, either the President or one of the parties in Congress threatens to make political hay in this election out of efforts by the other to cut back cost-of-living allowances and social security or defense spending it is going to be very unattractive for any one of the actors to take the lead.

Similarly, in the case of the Federal Reserve, it simply cannot risk its anti-inflationary credibility by easing up on its monetary targets in the absence of a firm and I believe bipartisan agreement to enact a very large deficit reduction program.

My judgment, simply from reading the newspapers and talking to people, is that large portions of the membership of both parties in the Congress are prepared to take toughminded action on all the necessary budget items.

I do not know, of course, what the Federal Reserve would do when confronted with the offer of such an accord as I have described. I would not rule out the possibility, however, that they might participate.

If the media accurately reported on the advice from the economic advisers whom the President overruled when he made his final budget decision, even those advisers might also find such an approach worthy of consideration.

There is only one of the actors who, at the moment, seems bent on a completely different course. That actor is President of the United States. But I am an optimist, Mr. Chairman, and I think in the face of the mounting evidence, he, too, will come around before long. I hope so.

Chairman **Domenici**. Thank you very much.

PREPARED STATEMENT OF CHARLES L. SCHULTZE,* SENIOR FELLOW, BROOKINGS INSTITUTION

Mr. Chairman and members of the Committee:

While no budgetary actions are irrevocable, the Congress this year is faced with the necessity to make decisions that will set the basic course of budgetary policy and affect the performance of the American economy for years to come. I would like to offer a few thoughts on four major questions that are relevant to those decisions:

1. How large is the budget deficit likely to be in the absence of further actions to reduce it? How big is the problem in front of you?
2. How important is it to lower the deficit? Is deficit reduction alone an answer to the century's economic problems? Should a large reduction in the deficit be accompanied by an easing of of monetary policy?
3. Can the deficit be reduced sufficiently by the Administration's proposed approach of small tax increases, exempting defense and social security from cuts, and concentrating the spending reductions in the remainder of the budget.
4. What are the major alternatives for making large reductions in the deficit?

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*The views expressed are my own and are not necessarily those of the officers, trustees, or other staff members of the Brookings Institution.

How Large is the Budget Deficit Likely to Be?

The most recent estimates of the budget deficit by both the Administration and the CBO, are based on the assumption that the Administration's budget reduction program is enacted in full. Unless one believes that this program will pass the Congress unchallenged, a more relevant estimate of the magnitude of the task facing the Congress is a measure of what the deficit would be on the basis of current laws and budget policies, in the absence of any actions to change them. What is the size of the problem you start with? Table 1 below shows the size of that current policy deficit -- based on both Administration and the most recent CBO estimates. (The estimates in Table 1 assume that the Administration's defense program goes forward unchanged.)

On either set of estimates the deficit, in the absence of further actions to reduce it, would rise to an unprecedented magnitude by 1985, especially when we remember that the calculation of both the CBO and the Administration assume an economic recovery beginning this year and lasting through 1985. Measured as a percent of GNP the highest non-recession deficit in postwar history was reached fiscal 1968, at the peak of the Vietnam War, when it was 3.0 percent, and that deficit helped set off a major inflation.

The estimates of CBO and the Administration differ because of alternative economic assumptions and technical judgements. The CBO economic assumptions are roughly similar to those of most private forecasters. The Administration's are more optimistic. An examination

Table 1. The Budget Threat: Current Policy Budget Deficits Before Reductions, Based on Administration and CBO Estimates; FY 1982-1985 (billions of dollars and percent)

	1982	1983	1984	1985
Billions of dollars:				
Administration	101	149	178	189
CBO	112	.172	216	252
Percent of GNP:				
Administration	3.3	4.4	4.7	4.5
CBO	3.7	5.0	5.7	6.0

Source: Author's calculations based on Administration and CBO Budget Documents. The estimates include the increase in interest payments on the public debt brought about because deficits themselves increase the public debt.

of areas where there are large technical differences -- such as farm price supports and revenues from offshore oil leases -- suggests that the CBO estimates are closer to what might be expected on the basis of past relationships.

For the remainder of the testimony I will use budget figures which average the two estimates, giving two-thirds weight to the CBO's numbers and one-third to those of the Administration. The resulting estimates still incorporate relatively optimistic economic assumptions; economic growth averages 4-1/2 percent a year between 1982 and 1985; inflation falls to 5-1/2 percent by 1985, unemployment 6.9 percent and interest rates on short term Treasury bills to 9 percent by 1985. The resulting deficits are:

	(fiscal year)			
	1982	1983	1984	1985
Billions of dollars:	108	165	203	230
Percent of GNP:	3.5	4.8	5.4	5.5

Clearly deficits of this size must be reduced. But deficit reductions alone are not enough. The Federal Reserve is now engaged on a course of monetary policy that is unprecedented in its tightness. If, under these circumstances, budget deficits rise to unprecedented heights the level of real interest rates will remain at intolerably high levels, with extremely severe consequences for the interest sensitive sectors of the economy. But the tax increases and spending cuts needed to reduce the deficit will tend to dampen the growth of the demand and spending in other areas of the economy, just at a time when Federal Reserve policy is also very heavily restricting economic growth. The combined degree of economic restraint from both fiscal and monetary policy may then be unnecessarily severe.

This line of reasoning suggests that if truly large reductions in the threatened deficit are put in place, it is imperative that they be accompanied by some cautious relaxation of the present course of monetary policy.

The Two Effects of Budget Deficits

The existence of a large and continuing federal budget deficit, during a period not characterized by recessions, affects the economy in two major ways.

In the first place, borrowing to finance that deficit absorbs private savings that would otherwise be available for investment in housing or business plant and equipment. Reducing the deficit, therefore, frees up private savings to support investment. Looking at the same phenomenon another way, the tax increases or government spending cuts that lower the deficit tend to reduce expenditures by consumers and government, leaving more resources available to produce factory buildings, machinery, or houses. Cutting the deficit thus tends to increase both the real and the financial resources available for investment purposes, and vice-versa. To the extent that the proceeds of tax cuts are saved, and not spent on consumer goods, this conclusion must be modified. That fraction of a deficit-creating tax cut which is saved doesn't reduce the financial or real resources available for investment (and vice-versa for a deficit reduction financed by tax increases).

While a reduction in the federal budget deficit increases the real and financial resources available for private investment -- by lowering consumption or government spending -- it does not itself generate that additional investment. Lower deficits do tend to produce some decline in interest rates, but there are no economic models which suggest that the decline will be large enough to induce the requisite additional investment. Taken by itself, therefore, a reduction (increase) in the deficit will lower (raise) total national expenditures and GNP. To maintain the level of total spending and GNP, if that is desired, a reduction in the deficit must be accompanied by an easing of monetary policy, to produce interest rates low enough to generate the additional private investment.

Thus, two different sets of considerations are relevant in deciding the appropriate size of the federal budget deficit:

- Lowering the deficit can change the mix of GNP; out of a given GNP a larger share becomes available for private investment.
- Reducing the deficit, with no offsetting change in

> monetary policy, will lower the level of demand, employment, and GNP from what they would have been with the higher deficit; to the extent the government wants to place that degree of restraint on total demand and employment, as a means of putting further downward pressure on inflation, reducing the deficit is a way to do so. But to the extent that only a change in mix is desired, then a deficit reduction must be accompanied by an easing of monetary policy.

To design a reasonable long term strategy for dealing with the prospective budget deficits that now face the country, it is therefore necessary to decide what we want with respect both to the level and the composition of economic activity. And it is impossible to decide on appropriate long term budgetary strategy without simultaneously making decisions about long term monetary policy.

The Question of Mix: Federal Deficits and the Investment Share of GNP

Table 2 summarizes postwar trends in the share of gross national income (=GNP) flowing into private savings and the availability of those savings for private investment. In order to assess the longer term implications of sustaining large budget deficits, it also projects the savings ratio and investment availability to 1985 under two different assumptions about the magnitude of the deficit that will have

Table 2. Private Savings and Its Uses in the United States, as a Percent of GNP, 1951-1980 and Projections to 1985

				1985	
	1951 to 1960	1961 to 1970	1971 to 1980	A: $230 billion deficit	B: $80 billion deficit
Total Private Savings	16.0	16.9	17.7	19.0	18.5
Personal	4.7	4.7	4.8	4.5	4.2
Business	11.3	11.7	12.0	13.2	13.0
State and local pension funds	...	0.5	0.9	1.3	1.3
Total Uses of Savings	16.1	16.8	17.9	19.0	18.5
Less: financing the federal deficit	0.2	0.5	1.9	5.5	1.9
Financing state and local deficits	...	0.5	-0.1	0	0
Net foreign investments	0.3	0.5	0.1	-0.3	0
Equals: amount available for private investment:	15.6	15.3	16.0	13.8	16.4

to be financed.

Private savings is made up of two major components: personal savings and the gross retained earnings of business firms (undistributed profits plus depreciation allowances).[1] As the table shows, the nation has modestly increased the share of income going to private savings in each of the last two decades. All of this increase has been in the form of human savings -- the personal saving share did not rise (and indeed in the last half of the 1970's it declined substantially). All the rise in the private saving ratio from the 1950's to the 1970's was absorbed by an increase in size of the federal deficit which had to be financed. But the effect of this on the availability of financial and real resources for private investment was moderated by a swing from deficit to a small surplus on the part of state and local governments and by the decline of U.S. foreign investment. Despite the rather large rise in the amount of savings required to finance the federal deficit, therefore, a slight increase in the availability of funds for private investment did take place.

To show the magnitude of the current problem, the projection to 1985 labeled "A" in the Table 2 incorporates the $230 billion federal deficit that will be forthcoming by 1985 if no actions are taken to reduce it. The "B" projection assumes that the deficit is reduced by $150 billion, to a level of $80 billion.[2]

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[1] The flow of savings into pension funds for employees of private firms is part of private savings. The net flow of funds into pension funds maintained by state and local governments on behalf of their employees is exactly the same in character and is thus classified under "private savings" in Table 2.

The estimate of private savings in the "A" projection assumes, optimistically, that individual and corporate tax reductions in the Economic Recovery Act of 1981 significantly raise private savings. While the Act does substantially lower effective tax rates from what they otherwise would be, the average effective tax rate on individuals falls only to about what it was in 1978 or 1979 and marginal effective rates for most taxpayers are similarly brought back to the levels of the late 1970's. Much of the tax reduction simply offsets bracket creep that otherwise would have occurred. Nevertheless the projection assumes that the personal savings rate out of disposable income would rise by a full percentage point, from the 5.6 percent it averaged in the last half of the 1980's to 6.6 percent in 1985. Business savings as a percent of GNP were assumed to continue on their modest upward trend and were then raised further by an amount equal to 60 percent of the corporate tax cut (the other 40 percent going to dividends).

State and local governments in the aggregate were assumed to run a

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2. Because actions to reduce the annual deficits between now and 1985 lower the public debt, and hence interest payments, a deficit reduction program of about $50, $90, and $125 billion in fiscal years 1983 through 1985, would produce a deficit reduction of $150 billion in 1985.

balanced budget (although the combination of cuts in federal grants-in-aid and the aftermath of events like Proposition 13 could put them in deficit). It was assumed that some part of the needed financing would come from abroad, in the form of a U.S current account deficit, but the magnitude of this relief is limited. Foreigners would be unwilling to finance a huge U.S. current account deficit, and exchange rate movements (a depreciation of the dollar) would limit financing from this source.

As shown in the last bank of numbers in Table 2 failure to reduce the federal deficit very substantially below the levels now in prospect would sharply lower the availability of funds for private investment. The 13-1/2 percent of GNP which would be available for investment is far below any postwar experience. Housing construction would necessarily fall even lower than at present. The "crowding out" of private investment would take place through the mechanism of very high interest rates, maintained over a long period of time. Since the nation has no experience with such a situation there is little basis on which to predict the consequences. But it is at least conceivable that severe financial strains would develop leading to a major credit "crunch" and a subsequent recession longer and deeper than any in the postwar period.

In would take a reduction in the 1985 deficit of almost $150 billion to make available for private investment (on relatively optimistic assumptions) a share of resources larger than that which prevailed in the 1970's. It is probably reasonable to assume that housing investment would not return fully to the same share of GNP it had in the 1970's, partly because mortgage interest rates are likely, in the best of circumstances to remain well above historical levels. Consequently, case "B" makes room for a somewhat larger rise, above the average of the 1970's, in the share of GNP going to business investment. But even with the major deficit reduction program that underlies case "B", the room for a rise in investment is modest, especially in view of the nation's poor productivity performance and its need for a sharp increase in investment. A year ago, Secretary of the Treasury Regan, appearing before the Congress, projected a rise in the private investment share of GNP of some 4 percentage points between now and 1986. It will take a massive deficit reduction effort to make room for only a small fraction of that increase.

So far, the discussion has assumed a particular path for the growth of total GNP, and concentrated on the question of its composition -- how much of the assumed GNP will be available for investment. But given the current trend of monetary policy which will yield very slow growth in the money supply and historically very high real interest rates over the foreseeable future, it is not at all clear that investment will be forthcoming in sufficient volume to absorb the real and financial resources available, even with a federal budget deficit that is reduced to 2 percent of GNP. In that case GNP will rise by less than the projections assume, and unemployment will remain high.

And so the second aspect of a deficit reduction must be considered -- its effect on the level and rate of growth in GNP and the relationship between deficits and monetary policy.

The Federal Budget and the Level of GNP

There is no historical precedent, outside of the two world wars, for a non-recession deficit equal to the 5.5 percent of GNP which is likely to occur without the inauguration of a major deficit reduction program. The stimulative effect of such a deficit on the demand for goods and services, especially in the consumer goods and defense industries, would be very great. While budget policy, without correction, would be stimulative to an unprecedented degree over the next three to four years, monetary policy has been set on an equally unprecedented course of restrictiveness. Already, even before the worst of the deficits have occurred and in the midst of a recession, long term interest rates both absolutely and in relation to inflation have climbed to postwar peaks, partly in expectation of this policy conflict.

Since there is no precedent either for the stimulative magnitude of the prospective deficits or the restrictiveness of the announced monetary policy, it is virtually impossible to analyze the ramifications of the conflict. Conventional analysis, looking to historical relationships between money, interest rates, deficits and private demand for goods and services, suggests an outcome in which the large tax cuts, the rapid defense buildup, and other elements adding to the deficit would generate enough growth in the non-interest sensitive parts of the economy to offset the effects of monetary policy, but perhaps not by enough to launch major new inflationary pressures. On average real interest rates would continue for the forseeable future to equal or exceed the current unprecedented levels of the last six months, but both interest rates and economic activity would fluctuate erratically. Interest sensitive industries -- autos, housing, inventory goods -- would continue at very depressed levels.[3]

Conventional analysis does not take into account what a long period of interest rates at this level would do to the financial viability of American business. Three to four more years of today's interest rates could cripple large parts of the thrift industry. For nonfinancial businesses, the threat of bankruptcy potential inability to cover debt service, and deteriorating credit worthiness could give rise to a phenomenon that has been avoided in the postwar period -- a financially induced economic contraction of long duration.

Large tax increases and spending cuts sufficient to reduce the budget deficit by the $150 billion shown in case "B" of Table 2 would lead to lower interest rates, but also to a slower growth of GNP. That is, the induced fall in interest rates would only partially offset the lower growth of demand brought about by the tax increases and spending cuts. The growth of GNP and employment would decline. The question is, what would that growth be and would it be lower than necessary to continue a policy of reducing inflation?

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[3] With today's tight money, unchecked budget deficits of the magnitude shown in case "A" of Table 2 would guarantee a highly erratic and unbalanced economy. With easier money those deficits would guarantee a renewal of inflation.

Typically in their first three years, postwar economic recoveries have produced an average annual growth rate of some 5 percent. While recoveries differed, real interest rates (nominal interest rates less the inflation rate) averaged 1-1/2 to 2 percent. With the partial exception of 1972-73 and 1978, these recoveries were not driven by stimulative budget policies. If real interest rates were now set at the same low (2 percent) level, and the deficit were reduced to about 2 percent of GNP (as in case "B") there is no reason to believe that the forces now making for recovery would be any weaker than the postwar average. Abstracting from whether it would have inflationary consequences, economic growth of 5 percent a year for the next several years would be possible (lowering the unemployment rate to perhaps 6 percent or less by 1985). But with the money supply scheduled to grow at only 4 to 4-1/2 percent a year, and inflation declining only gradually over the next three years, even a major deficit reduction plan is still likely to leave real interest rates far above their usual recovery levels. Long term interest rates are likely to average five to seven percent, rather than two percent, above inflation. Even without factoring in the effects of the continued high interest rates on the financial structure of business, economic growth would, therefore not be likely to average above 2-1/2 or at best 3 percent per year. In that case the unemployment rate would not fall much below 8-1/2 percent over the next three to four years.

A policy under which unemployment averages in the neighborhood of 8-1/2 percent for the foreseeable future, however, is more rigorous than necessary to maintain progress in reducing inflation. With a truly large deficit reduction program in place, it would be possible to ease monetary policy cautiously, without abandoning the fight against inflation, aiming perhaps to raise the average growth of GNP during the 1982-185 period by a percentage point or so, to about 4 percent. Conceivably, of course, continued tight money and unprecedented levels of interest rates would stimulate the public to invent innovative ways to conserve their holdings of cash balances, so that the Fed's current money targets would permit lower interest rates and higher growth. But this would be easier money achieved by sheer good luck rather than design, and surely such a development can't be counted on.

In summary a major deficit reduction program is called for -- sufficient to lower the threatened deficit by at least $150 billion. But once credible actions are underway to produce a deficit reduction that large, or larger, some easing in monetary policy ought to be forthcoming.

Reducing the Deficit: The Administration's Approach

Budget actions which provide substantial reductions in the deficit over several years bring an added bonus; because they slow the growth of the public debt they lower expenditures for interest payments.[4] Hence a combination of tax increases and spending cuts starting at some $50 billion in 1983 and growing to $125 billion in 1985 would make possible the target deficit reduction of $150 billion in 1985.

The Administration has proposed a deficit reduction program which, by 1985, would amount to some $90 billion.[5] That deficit reduction program seeks to maintain intact the basic thrust of the Administration's 1981 economic and budgetary program: the planned buildup in defense spending would go forward unchanged, social security programs would not be cut, only small tax increases would be proposed, and the bulk of the budget cuts would be concentrated in the same broad area as were the spending cuts last year -- i.e., in the 25 percent of the federal budget outside of defense, interest, and entitlement programs.

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[4] The lower deficits would also bring somewhat lower interest rates, even without a change in monetary policy. However, the economic assumptions used in both the CBO and Administration projections already incorporate a substantial fall in real interest rates. A further reduction seems unlikely.

[5] According to the Administration's own estimates its deficit reduction program would result in savings of some $100 billion by 1981. However, as a recent analysis by the CBO has pointed out, several of the proposed savings are questionable, especially the $5 billion additional revenue from offshore oil receipts, the $4 billion in extra sales of public land and other property, and $4 billion in savings from lower growth in the nation's medical care costs which was imputed to a health care legislative program about which specifics are not yet available. The Administration's estimated $100 billion estimate of savings has therefore been discounted conservatively by $10 billion.

Because the Administration's approach to deficit reduction exempts defense and social security and precludes any large tax increases, it necessarily concentrates the cuts in a relatively narrow part of the budget -- one which was already slashed sharply last year. Due to this concentration on a small part of the total budget, the additional spending reductions proposed by the Administration, coming on top of last year's cuts, would require quite drastic reductions in many federal activities. As shown in Table 3, for example, federal expenditures on all civilian programs, other than net interest and payments to individuals, would be cut almost in half between 1980 and 1985 when measured in inflation adjusted terms. As a share of GNP, these federal programs -- covering such diverse activities as support of education and training, R & D, maintenance of the National Parks, the expenses of the FBI and construction of federal-aid highways -- would fall to levels below any reached in the last forty years. Table 4 illustrates the magnitude of the reductions for a number of particular federal programs. While the federal government would remain a major force in channeling cash and payments for medical care between taxpayers and various beneficiaries, its role in delivering or supporting state and local delivery of public services would be radically reduced. Precisely because the service support and delivery

Table 3. Expenditures for "Payments to Individuals" and "All Other" Federal Civilian Programs (excluding interest), Assuming Enactment of the Administration's Current Proposals
(in constant prices and as a percent of GNP)

A. Constant (FY 1981) Prices (billions of dollars)

	Actual					Proposed	
	1940	1950	1960	1970	1980	1983	1985
Payments to individuals[a]	9.2	44.6	62.4	132.8	295.4	319.8	326.5
All other programs[b]	47.5	60.4	59.4	98.8	141.7	88.9	75.5

B. Percent of GNP

	Actual					Proposed	
	1940	1950	1960	1970	1980	1983	1985
Payments to individuals[a]	1.7	5.1	9.7	6.5	10.6	10.7	10.0
All other programs[b]	5.9	4.6	3.5	4.4	5.0	3.0	2.3

NOTE: This table is derived from Administration's budget estimates.

a. All programs labeled in the budget category "payments to individuals" except military retirement (included in "defense"). Its major components are: civilian retirement and insurance programs, Medicare and Medicaid, welfare (AFDC, SSI and food stamps), student loans, housing assistance and veteran's pensions and compensation.

b. The "all other" program category shown in the budget document nets out several major categories of "offsetting receipts", which are treated as negative expenditures -- receipts from offshore oil leases, sale of federal land (from 1983 on) and the federal contribution to civil service retirement. The "all other" category in this table is gross of these asset sales.

Table 4. Percentage Reduction in Outlays for Selected Programs, Adjusted for Inflation, 1981 - 1985[a]

	Percent change
Criminal justice assistance	-90
Training and job programs	-72
Energy research and development	-62
Education	-50
Recreational resources	-43
EPA regulations enforcement and research	-42
Social services	-41
Transportation	-35
Area and regional development	-35
Management of national forests	-29

a. Based on Administration budget estimates, deflated by the implicit deflator for "All other programs" in Table 22, p. 9-61 of the Budget of the United States, Fiscal year 1983.

role of the federal government, measured in dollars, is relatively small compared to its role in providing defense and making transfer payments, even radical reductions in this role fail, by a wide margin, to eliminate the swelling budget deficit.

I do not wish to suggest that there is no room for additional cuts in this area of the budget. There are some of the Administration's proposed cuts, which it seems to me, have merit. And the Congressional Budget Office has identified a number of spending cuts, outside of entitlement programs, which deserve serious consideration and which would reduce outlays some $18 billion by fiscal 1985.

In my judgement, however, there are two major reasons to turn to other areas of the budget to find additional reductions: , First, apart from the questions it raises on substantive grounds, concentrating budget reductions in the very narrow area proposed by the Administration would make it impossible to secure the social and political consensus needed to reduce deficit by the needed amount. And second, even complete enactment of the Administration's program would still leave an additional $35 to $40 billion in budget reductions to be found (by 1985). There can be no major "untouchable" elements in the budget. The social and political consensus required to take actions of the magnitude that is called for will not be forthcoming if any major sector of the budget or of society is exempt. In particular, the program must include cuts in defense[6] and social security and must require some sacrifice from those who received the bulk of the benefits of last year's individual tax cuts.

Some Additional Candidates for Budget Reduction

The task of finding deficit reductions that, by 1985, will add up to something in the neighborhood of $125 billion is no mean task. But once the area of search is enlarged to encompass action on taxes, on social security and on defense, the problem is at least not insuperable. I am not capable of proposing nor do I intend to propose a comprehensive list of actions. But it may be useful to list several possiblities.

1. General Income Tax Increases

While there are numerous ways to provide a general income tax increase, two have recently been suggested; an indefinite delay in the third, 10 percent, increment of last year's tax cut, due to take effect on July 1983 and a delay in the introduction of inflation indexing, scheduled to begin in 1985. The third stage of the individual tax cut accounts for about 40 percent of the tax rate reduction enacted last year.

An alternative, that with one exception, would be quite similar in its effect on individual taxpayers, would be the temporary imposition

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6. If maintaining the present rapid pace of the defense buildup were clearly essential to national security, an exemption might be feasible. But this is by no means the case and is not generally perceived in Congress to be the case.

of an income tax surcharge; each taxpayer would calculate his tax and then add a specified percentage (the surcharge) to that tax. Since the top bracket rate was reduced from 70 to 50 percent in the first round of last year's tax cut, postponement of the third stage of the tax cut would have only a slight affect on very high income taxpayers. The surcharge, on the other hand, would affect all taxpayers proportionately, and -- to the extent it was desired to stress an even-handed distribution of the burden of deficit reduction -- might therefore be a superior alternative.

Table 5, which shows the revenue gains from the various alternatives, does not include a surcharge or other increase for corporate taxes. Substantial criticism can indeed be leveled at the particular *structure* of business investment incentives included in last year's Economic Recovery Tax Act.[7] Nevertheless, enacting structural changes in those incentives is highly unlikely to be undertaken this year, and it would be unwise at the present time simply to lower the overall level of incentives provided by last year's Act.

All of the proposals suggested above would raise marginal tax rates, especially on middle and upper middle income taypayers (relative to the rates under ERTA when fully in effect). But economic incentives

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[7] See for example the vastly different effects on rates of return for investment in various types of plant and equipment as shown in the *1982 Economic Report of the President*, Table 5.5, p. 123.

Table 5. Revenue Gains from Alternative Income Tax Increases or Deferrals
(billions of dollars)

	1983	1985
Delay third 1983 stage of tax reduction under the Economic Recovery Tax Act of 1981	9	40
12 percent surcharge on individual income tax	37	42
Delay indexing	0	12

would not deteriorate compared to the current situation. Under the Economic Recovery Tax Act tax cuts for individuals would amount to some $128 billion by 1985. Between October 1981 and 1985 bracket creep due to inflation (using the CBO estimates of inflation) would have raised taxes by $71 billion. Deferral of the third stage of the ERTA, or a 12 percent surcharge, plus postponement of indexing, would still leave the value of the ERA tax cut at $75 billion — an amount that would almost exactly offset bracket creep. Individual taxpayers would fare differently, with lower and middle income taxpayers being better off under the surcharge. On balance, however, neither approach would significantly worsen economic incentives for individuals compared to the situation in 1981, although the potential improvement under the full ERTA would not be forthcoming.

2. Other Tax Proposals

The Administration has proposed specific reforms and related tax changes designed to yield $10 billion of additional revenues in FY 1983 and over $17 billion in 1985. The Congressional Budget Office has identified a very wide range of "loophole closing" measures that add to $34 billion and $72 billion in 1983 and 1985 respectively.[8]

Several of these reforms are particularly relevant to today's problems because they would either reward savings, provide incentives to hold down costs, or address, on the tax side, some of the problems of entitlement programs. (See Table 6.)

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[8] Reducing the Federal Budget: Strategies and Options, (February 1982).

One such change, for example, would be a limitation on the tax free portion of employer contributions to medical care plans to $120 per month. The availability of untaxed "low-dollar coverage" insurance, as part of employer paid fringe benefits, discourages the provision of health insurance with significant deductibles and coinsurance. (Taking $100 in the form of a wage increase is taxable; taking $100 in the form of a "richer" medical plan with reduced deductibles or coinsurance in the medical plan is tax free.) As a consequence the medical care system of the nation continually evolves in the direction of removing incentives for the provision of more efficient and lower cost medical care.

Eliminating the deductibility of interest on consumer installment debt would remove an anomaly in the U.S. tax code that subsidizes consumer borrowing and penalizes saving.

There are several tax reforms that would improve the fairness of entitlement programs -- taxing fully the benefits from unemployment compensation and taxing one-half the retirement benefits from social security recipients earning above $25,000 for couples (and $20,000 for single individuals).

The revenue yield from these various tax measures is shown in Table 6.

Table 6. Revenue Gains from Selected Tax Reforms
(fiscal year; billions of dollars)

	1983	1985
Administration proposals:		
Primarily business firms	9.2	13.3
Primarily individuals	1.8	2.5
Sub total	10.6	15.8
Reforms that help increase savings and/or reduce costs		
Terminate deductibility of consumer interest payments	1.2	8.1
Limit tax free employer contributions for health plans to $120 a month	2.5	4.4
Sub total	3.7	12.5
Reform Tax Treatment of Entitlement Programs		
Tax 1/2 income of retirement benefits for social security recipients with income above $20,000/$25,000	1.6	2.3
Tax all unemployment insurance benefits	1.9	1.7
Sub total	3.5	4.0
GRAND TOTAL	17.8	32.3

Defense Spending

The defense buildup proposed by the Administration would increase defense outlays between fiscal 1981 and 1985 by almost 9 percent a year faster than the inflation. By 1985 defense outlays will approach $300 billion. The planned growth of R&D and procurement is even more dramatic -- a 75 to 80 percent rise in the real value of procurement and R&D budget authority in four years.

It is widely agreed that the defense budget was underfunded in the 1970's. An intensified program of investment and readiness improvement is indeed warranted. Some of the elements of the currently planned buildup are very questionable however. Do we need a Navy designed with the capability of attacking the Soviet fleet in its home ports? Do we need an MX missile in Minuteman silos. And more important, is not the pace of the buildup too fast even from the standpoint of national security?

An excessively rapid buildup in defense procurement will most assuredly create skill bottlenecks and a scarcity of capacity and managerial talent in important segments of our defense industries. The resulting cost overruns will not be fully financed. The subsequent budget squeeze will not force out the heavy procurement and glamorous weapons surplus. If past history is any guide the squeeze is likely to eliminate expenditures on standard equipment for the ground forces, and such things as ammunition reserves, fuel used in training flights, live use of expensive weaponry in combat training, and a whole gamut of items whose consequences are not so easily seen or measured. The end result of an overly ambitious rate of defense buildup will be to leave our armed forces with too small a quantity of very high priced weapons, and with reduced readiness and less capacity to deploy, use, and maintain them in combat.

I have no menu of specific reductions to offer. But a realistic initial target for the Congress to consider might be the provision of funds for approximately a 5 to 6 percent a year real increase in defense spending. Such an increase would still permit a substantial and expeditious strengthening of the nation's armed forces. Because of the lead times involved the reduction in actual spending would be small in 1983, but would build up to some $25 billion a year by 1985.

The Need for National Accord on Economic Policy

I think it is possible to design a deficit reduction package of sufficient magnitude to do the job. But, as I said earlier, what is needed is not simply a large reduction in the prospective budget deficit, but simultaneously an easing of the Federal Reserve's current stance of monetary policy. There are some major problems, however, in designing and putting into place a new policy that involves both tighter budgets and easier money. For several years now, it has been commonplace for high government officials, many financial executives, and some prominent economists to equate the successful reduction of inflation with success in achieving a steady reduction in the growth of the money supply. The "toughness" and credibility of the Federal Reserve has come to be judged, by a large number of vocal and influential critics, in terms of how firmly the Fed refrains from raising its monetary targets in the fact of growing strains and how successful it is in meeting those targets -- annually, quarterly, and according to some critics, even monthly. The simple view that anti-inflationary virtue consists solely in a slow growth in money, however inaccurate -- especially under the circumstances we are discussing -- has gained wide credence. Hence the Federal Reserve probably faces, and certainly believes it faces, the problem of worsened expectations in the event that it proceeded either to raise its targets for money growth, or, to overrun the existing ones. It is widely believed that participants in financial markets would interpret such action as a weakening of anti-inflationary resolve, as a consequence of which long term interest rate might rise rather than fall.

A quite different problem arises for the Congress in trying to put into place an integrated approach which substantially reduces the deficit while moderately easing monetary policy. There are four independent sets of actors who must come into broad agreement to put such a policy together -- the Executive, the leadership of both parties in the Congress, and the Federal Reserve.

Without an explicit agreement or accord, each party will find it difficult to act, for quite different reasons If, for example, either the President or one of the parties in the Congress threatens to make political capital in this election out of efforts by the other parties to cut defense spending or scale back cost-of-living allowances in social security, it will be very unattractive for any one of the actors to take the lead. And if any one major element of the budget, or of society, is exempted from bearing some part of the burden, the coalition needed to enact the necessary package of measures cannot be formed. Similarly, in the case of the Federal Reserve, it cannot risk its anti-inflationary credibility by easing up on its monetary targets in the absence of a firm, and I believe bipartisan agreement, to enact a very large deficit reduction package.

The evidence condemning the present course of policy -- very tight money and very loose budgets -- grows increasingly clear. It is my judgement, simply from reading the newspapers and talking to people, that large portions of the membership of both parties in the Congress are prepared to take tough-minded action on all the necessary budget fronts. I do not know, of course, what the Federal Reserve would do, confronted with the offer of such an accord as I have described. But I would not rule out the possibility that they would participate. If the media accurately reported on the advice from the economic advisers whom the President overruled when he made his final budget decisions, those advisers might also find such an approach worthy of consideration. There is only one of the actors who, at the moment, seems bent on a completely different course -- the President of the United States. As an optimist, I believe that in the face of the mounting evidence he too will come around before long.

Chairman **Domenici**. I will tell you frankly the three of you have given support for what I have been thinking so I do not have very many questions, but I would like to say that you all seem to be on the right course that you cannot fit restraint in this budget without addressing entitlements.

That is obviously detailed, work you have done, Doctor, to try to work on COLA's, and I know of your past work, Charlie, in that regard, and you have explicitly stated it here.

I want to just address a few remarks that may be helpful on your end in building your courage to address COLA's. I will try to send you this in writing after today, but I do not think it would be very difficult with the help of the President to get some dramatic temporary relief from the COLA's.

BILLIONS COULD BE SAVED BY FREEZING COLA'S

While I would agree with you Rudy that the entitlement changes in the pension programs are a long-term effort, I would give you these numbers. First, if you froze COLA's for 1 year on all pensions, and that includes social security, the savings in 1983 would be in the neighborhood of $20 billion.

Since that reduction is compounded under current law, savings over the 3 years is $60 billion. No, that is wrong.

Dr. **Schultze**. It would be more than that.

Chairman **Domenici**. The savings by 1985 will be $60 billion. Now, why would even the moral commitment that you refer to Mr. Penner, why could it not be addressed right now?

Let me give you some numbers. Since 1971 through 1980, the compounded increases in social security amounted to 205 percent. The compounded increases for Federal employees retired amounts to 176 percent. The CPI for the same period compounded is 134 percent.

We will run that one before we send you the memo, because we believe the CPI for that period is higher than the average wage increase for American working men and women. If it is not, there has been a bonus built in not by any contract of the difference of 134 and 205 or 134 and 176.

We will get the dollar number that the American Treasury has paid because of that, and it will be on the memo that I send to you. It is in the billions that that difference has extended to them if you start with realistic inflation add-on over this period.

In addition, Federal employee retirement cost the Federal Government 36 percent of payroll which is our best estimate right now. For every $100 we pay as employers, $36 is for pensions and health.

Our first run says that is the most expensive program in all the world, 36 percent of payroll. They pay 7 and we pay 7. That is 14. Fourteen from 36 means, if it was an annuity that was assumed, somehow in the shuffle the taxpayer pays 22 percent of the cost and the contributors pay 14.

NOT ASKING FOR THE INCREDIBLE

Now, it would seem to me that if you take either your approach or your approach which says do something quick, make it equitable, across-the-board and include some tax increases and some military cuts, it appears to me that that is not an incredible thing to ask of the present pensioners unless one would assume that most of them have not been the beneficiaries of the increases because they are very current or as I see it, that they are going to leave the system rather quickly and will have lost the year.

Those are the only two that I can think of that detract from asking that you do it in the name of the moral commitment. I am going to push this one very hard, and I am going to show the President these numbers.

It appears to me we could have done this last year with his help. The numbers would not have been much different, and I think looking out there at them and telling them that, I think they would have accepted it.

I think things are worse. They might accept it now.

We also have an enormous distortion occurring in the Federal employee retirement program. You are probably more aware of it having been over there most recently, but this is an interesting fact.

A GS-14, retired 10 years ago under Federal employee retired, makes $8,800 a year more than current GS-14s. That is an impossible situation. Their pay went up very slowly.

RETIREMENT PAYS MORE THAN WORKING

The retiree went up at 176 percent. That conclusion—and that is the same in military retiree—leads you to believe you should not work or get out as fast as you can or that you get paid more to be on retirement than for current work.

All of those cry out, it seems to me, for adjustment, and it appears that there is some growing knowledge, perhaps not with these specifics, but growing knowledge that this is the problem.

Now, aside from the fact that interest will eat up all the savings we made, we made $40 billion in savings, most in discretionary accounts, the entitlements, if you define them as the pension programs plus medicare, medicaid, that package of programs is still going up at greater rate than current inflation.

We did not make any headway in reducing those. If you leave those alone, they are still growing and are 50 plus percent of the budget. So frequently people say you have done all you can in those areas and to leave them alone.

I just cite you these numbers and I will send them to you because I think they ought to get out there among the American people and you have opportunities to talk about it.

Now, that is all I have for the day because I think the two approaches, Dr. Schultze and Dr. Penner, you both recognize the political difficulties, the need for aid package, the need for multiyear credibility which is the most difficult problem we have got.

We could come up with a this-year package, but we are not very equipped to come up with three-year credible packages. If they want to, they can.

MAKING IT CREDIBLE

My conclusion is the best way to make it credible is to look at entitlements, because they are the automatics that, by change of law, automatically change downward.

Military and discretionary appropriations, they are annualized. You budget them annually. The best you can do there is target and then the President has the hammer there. So there is some credibility built into that.

If you reach the targets in 1984, they have to be appropriate. So I thank you for your presentation. If you have any comments on the pensions, I would be glad to take them, and then I will yield to Senator Exon.

Dr. PENNER. My only comment is that I could not agree with you more. I think that is exactly the right track. There are probably some inequities, as you noted with regard to recent retirees under social security and things like that.

We do need a general rule that allows drastic action and I hope you did not misunderstand some things I said.

I do not think an action such as you propose under our current dire circumstances, would really be a violation of any moral contract.

Dr. SCHULTZE. You are more ambitious than I am, but that is neither hear nor there. One piece of additional material for your mill. As a matter of fact, I think on a kind of temporary basis, this could be the rationale for your 8 percent.

I have not checked this number for about 8 or 9 months, but during the period 1977 through 1980, 4 years, the CPI went up by 8 percent more than wages.

Chairman DOMENICI. Yes.

Dr. SCHULTZE. The working person was absorbing the OPEC oil increase so the wages came down relative to prices. I think taking 8 percent out in 1 year is maybe a little rough.

But since the big deficit problem is not just 1983, it is going to do in 4 and 4 which turns out to come to the same number that Mr. Santow had gets you by 1984 your 8 percent.

Chairman DOMENICI. I agree.

RATIONALE FOR FOUR-AND-FOUR APPROACH

Dr. SCHULTZE. You do not take on structural problems until the Commission reports, probably. It is going to be very difficult. So it seems to me you have a rationale for a nice 4-and-4 approach.

I would add one thing, however. Again, and what you said, there is no disagreement, that just as—you are going to ask the pensioners, whatever your rationale, to do it and politically it seems to me you also have to be sure you are doing something else elsewhere in the budget, and I point particularly to taxes and defense.

Chairman DOMENICI. No question. You have read my ideas. I say the same thing. In fact, I think you can look at the Tax Code with that in mind.

The loophole end can address those that would escape taxation, be they corporate or individual that earn an awful lot of real disposable money.

That counters it, and you would have some sense of equity about the situation.

Dr. Santow, I, in no way, discount your notion. It comes out very close on arithmetic and the same rationale that it is time to make an adjustment while we are waiting around for the full Commission to still make sense over a 3-year period to save the same amount of money.

I yield to Senator Exon.

Thank you gentleman.

CURRENT UNFUNDED LIABILITY ON MILITARY PENSIONS

Senator **Exon**. Thank you, Mr. Chairman, and thank you gentlemen for being here. I really enjoyed your testimony. I think it is excellent. You have been here before, and you have helped us before, and I think you are helping us now.

Just to throw another further problem into what we are facing in the future. I was advised the other day in the Armed Services Committee that the current known unfunded liability on military pensions alone is somewhere around $435 billion that is facing us in the future as we continue our appropriations.

That has not even been worked into our problems, but it is certainly driving the future military expenditures when we look to the future.

Mr. Chairman, I enjoyed your well thought out statement on COLA's and the support that you people have lent to that. I agree that the President pressed it last year.

I think we could have been successful with that. If I remember correctly in this particular committee, there was a lowly junior Senator down there that cast the tie vote, and the esteemed knowledgeable chairman of our committee cast the passing vote.

We passed that COLA adjustment by, I think, one vote only in this committee. I have talked to a lot of my retired people out in Nebraska, and they do not have any quarrel with the COLA adjustment.

PEOPLE ARE MORE FAMILIAR WITH CPI

Let me ask you, Dr. Santow, though, on your particular proposal. Are you locked into just the CPI or would your proposal have the same merit if it was the CPI or the wage price increase whichever is lower?

Dr. **Santow**. Well, the CPI has some advantages. No. 1 is the fact that it appears in the newspaper once a month. People are familiar with it.

I think when you start going to other indices, that the familiarity with such indices is much less.

Senator **Exon**. It is a public relations number. Is that what you are saying?

Dr. **Santow**. Well, that is part of it, and I think also that while the CPI may not be as good as the GNP deflator or some derivation of the deflator, its accuracy can be improved by taking the average of the fourth quarter to the average of the fourth quarter. That approach will get rid of at least some of the month-to-month gyrations that you might have. I used the CPI not so much from a theoretical point of view as a practical point of view.

Senator **Exon**. I would just simply say, Dr. Santow, though, if we would go to a wage price index and start working it into our formula we could maybe have a better understanding of the people that there is no social security trust fund per se.

It is basically a situation where we are paying out money in Washington as it comes in from the people who are working and earning wages today.

You know, I get so many letters from people back home that say how much money do I have in my trust fund, and they seem to think it is kind of like a private pension fund that it is acrued and it is there.

And we all know basically in operation that is not the case. I guess you said, Dr. Santow, that you made suggestions that you thought it would be palatable to the administration.

The only quarrel I would have with your one, two, three, four proposals here is that it might be all too palatable to the administration, because I would suggest if we enacted these and only these to the exclusion of defense and other areas, we would be hitting very hard the people that I think were hit pretty hard with the overall action that we took last year.

In other words, would this not be quite difficult on the average person and the average wage earner in America the way you have devised it without extending it further to defense and some other areas?

Dr. **Santow**. The point that I made at the beginning was that this was not a full list. In other words, I took basically four things that seemed very obvious to me that I felt could get passed in a reasonable period of time.

STICK TO ONE BILL

I am sure there are other things that could be added to the list. I will go back and I will make the point again that Congress is going to have to unite behind one bill or one proposal.

I do not think you can go six or seven different ways with six or seven different proposals. You are going to have to come out with one bill. And, of course, if you start getting into the more controversial areas, you would endanger having the overall bill itself not passed.

So it was my philosophy to use just these four areas.

Senator **Exon**. I was delighted that you made that suggestion because so far as I know I am only one of two members, maybe one other Senator who has advanced it as not part of my own, so I was delighted that you were supporting me.

Charlie.

Dr. **Schultze**. Well, since we are all agreeing on everything I might as well disagree just a little bit. The one problem you have got to worry about with the combination of the natural gas decontrol and the oil import fees is that, depending on exactly how you do it, during the year you drive up the CPI by 2, 3 percent.

For example, the last Department of Energy study of the impact, at least, of instant decontrol on natural gas, if I remember right, was about a 2-percent increase in CPI.

If you put a 10- to 15-percent import fee on, you get maybe another 1 percent, and that is a little bit much to swallow.

So if you are going to do one, my guess is only do one. It is a little much to swallow if you do both of them at the same time. I think you got a real problem there.

Dr. **Santow**. Yes, but let me point out that if you are ever going to do something like that, it is at a time when there is falling prices in general, and a special softness in the oil area.

If this were a period where we were back at double digit inflation, it would be exceptionally difficult to get these things through.

But again, the purpose was of the oil import fee to tie the revenue to something that the administration wants on the other side.

Dr. **Penner**. I would just like to make two points. I wish Mr. Kapra was here, because he has convinced me that the windfall tax on natural gas is just not appropriate for this year.

PRICE CONTROLS ON NATURAL GAS COMPLICATED

His argument is that the current price controls on natural gas are so extraordinarily complicated that they make the windfall tax on oil look simple by comparison to a windfall tax on natural gas.

And I regard the tax on oil as beyond human understanding, and so I think there are just hundreds of issues that would have to be worked out before you could leave a tax on natural gas.

Again, I return to my need for speed in all of this.

I would like to make a point about the COLA's which sounds very technical and minor, but I do not really think it is.

While Charlie said you should await the commission report to make longrun structural changes, I think that if you do put a cap or a freeze on the COLA's for the existing retirees that equity demands that you use the same principle applied for the current wage indexing of the formula that determines future benefits.

To me, actually, the longrun social security problem really relates to the indexing of that formula more than it does to the current retirees.

But my point is really a simpler one than that. If you do freeze the current retirees and do not do anything with that formula, you get the very odd result that the new cohorts of retirees do very well relative to the already retired people who you have frozen.

Senator **Exon**. Two quick questions. In the first place, I asked the last panel this. I would ask you this, and I will narrow it this way.

Assuming that we would accept the President's budget, for the sake of discussion, assuming we just accept it the way it is and if we would do that, would you suggest—you addressed it, Mr. Penner, and I took it your first statement was you did not think we should tamper with the July 1982 tax cut.

Then later on, I guess you kind of reversed yourself and said maybe we should. I shared your earlier concern about right in the depth of a recession if we announce we are not going to go ahead with the tax cuts in July, what problem would that cause?

I would think it would be monumental even though I am sure it is driving the deficit. What do you have to say about that?

AVOID CHANGING 1982 TAX CUT

Dr. **Penner**. In principle, I would like to avoid changing the July 1982 tax cut, and my concern about deficits does not extend to fiscal 1982 or even fiscal 1983 so much.

It is the longrun growth in deficits that is disturbing. When I seemed to step back from that notion, I just meant that if it is necessary to do something about that 1982 tax cut as part of some political deal to get some of the other things that I would like to see in place for 1983, 1984, and 1985 I would not stand stubbornly on the principle that I enunciated.

But all other things equal, I would certainly rather not tamper with the 1982 tax cut.

Dr. **Schultze**. Senator, it seems to me you could make a good argument that you ought not, on overall economic grounds, tamper with the July 1982 cut.

IMPOSE A SURCHARGE

But I do think there is reason to delay indefinitely the July 1983 tax cut. Now, an alternative to that which can give you almost the same result but has a little bit of an advantage is the idea of imposing a surcharge.

Let the tax cut go into effect, but impose a surcharge where everybody simply calculates their taxes and adds a given percentage. It has the advantage, that if you simply defer the July 1983 stage of the tax cut, then all the top bracket rates will have been moved down to 50 percent.

So that the impact of that will be very light on anyone in the quite high income brackets and be the heaviest around the middle and upper middle income groups, whereas the surcharge could do it more, "equitably," if you are trying to put together a package where everybody feels that everybody is playing.

Maybe a surcharge might be a little bit better way to do it than deferring that third stage, but I would not touch the second stage.

Senator **Exon**. Dr. Santow, do you care to comment?

GETTING TAX REDUCTIONS INTO SAVINGS IS THE OBJECTIVE

Dr. **Santow**. Well, as I stated in the fourth point, I do not believe that any of these things will be palatable to the President, and therefore, it seems to me the objective is to figure out how we can get some of these tax reductions into savings and investment.

So that is why I have made the assumption that it is politically impossible to stop the 10-percent reduction. So now is there a way that we can take those funds and have them used in the savings and investment process.

That is basically the genesis of the fourth point here.

Senator **Exon**. Well, one last question, Mr. Chairman, and it may be a simple yes or no answer. If not, expand a little bit. Then I am finished.

From the standpoint of gaining some credibility insofar as what we are going to do here in Government, and it was testified to before and I suspect you generally agree that there is not much confidence out there in what we do up here.

NO MERIT IN EARMARKING TAX INCOME FOR NATIONAL DEBT

Is there any merit at all to earmarking some source of tax income into an untouchable fund as far as spending is concerned that would be used exclusively for application to the national debt principal only?

In other words, do not forget about deficits, but something to show some concern that we are going to—we never talk about reducing the national debt anymore. We keep talking about just fighting the deficit situation.

Is there any merit to anything like that from the standpoint of establishing some credibility?

Dr. SCHULTZE. No, sir. Let me note, first, just the shear arithmetic of it. In order to do that, you got to run a surplus.

Suppose, for example, you cut the budget to $100 billion deficit, just for the heck of it, and then said I am now going to take another $50 billion in taxes and put it to retiring the debt.

Well, you cannot do that if you got $100 billion deficit there. You can take your $50 billion and name it anything you want.

Senator EXON. But it is still part of the debt?

Dr. SCHULTZE. Well, if you got a $100 billion deficit, and you take $50 billion in taxes that could have reduced the $100 to $50 billion and do not do that and put it aside to retire the debt, then you are going to be with your lefthand having $100 billion deficit and with your righthand—I do not see quite the point.

Senator EXON. OK. Supposing we would decide here that we could put a tax on imported oil and earmark $2 to $10 billion a year just strictly to go on the national debt as opposed to the deficit, would your same objections apply, Charlie?

Dr. SCHULTZE. Yes, sir. Suppose before you did that—I will go back to my numbers. You were going to run—make your number up. You got the deficit way down to $50 billion——

Senator EXON. Let us be optimistic.

Dr. SCHULTZE. Let us be optimistic. [Laughter.]

Then you said I am going to put, just for the heck of it, a $10 billion tax on imported oil. Well, you could either use the $10 billion tax to get the $50 billion deficit down to $40 billion or you could take the $10 billion and buy back Government debt but have to go out and issue $50 billion worth of new debt instead of $40 billion, and you end up right where you started from.

That is my only point.

Chairman DOMENICI. Well, at some point you might not.

Dr. SCHULTZE. My point is if you then want to run a surplus, there are only two things that Government can do with the surplus, if you really run one.

Senator EXON. Spend it or pay off——

Dr. SCHULTZE. Cash. No, no. To literally run the surplus, it means by definition you are not spending it. I have pursued it far enough.

Senator **Exon**. Dr. Santow.

EXPENDITURES SUBJECT TO LIMITATION CEILINGS

Dr. **Santow**. I think there would be something that would be far more useful. I think I recommended this either the last time I testified or the time before and that is that instead of having debt subject to limitation ceilings, you ought to have expenditure quarterly subject to limitation ceilings. The Government would be allowed to spend only a certain amount each quarter unless Congress gave them additional permission. I think that is how you gain credibility for this committee.

Chairman **Domenici**. Well, let me add this, Senator, if you will permit me. There is a peripheral issue, Dr. Schultze. There are some who think the American people would support a tax to get rid of the deficit.

They do not support any taxes. No people do, but one reason for talking about a tax for defense is that maybe if you made the case they would collectively be supported.

The same reason on the political front is behind the notion that the Senator expressed which is around. People have been suggesting it.

I think U.S. News or Newsweek had a major feature by someone saying it would be a good idea, and stressed the idea that the American people might want that to happen.

I am not disagreeing that it is just left and righthand so long as you were in deficit there is no question about it.

Dr. **Penner**. I was just going to make exactly the same point, that while I agree with the substance of everything that Charlie said, the only possible appeal this sort of idea has to me is as part of a public relations gimmick that makes some tax increase more palatable.

But frankly, I think that the most important need in budgeting these days in general is credibility, and this sort of idea would, in fact, be a kind of a trick, a kind of a gimmick.

PUT THE REAL PROBLEM BEFORE THE PEOPLE

I would much prefer just, at this moment in history, to put the real problem up before the American people and have the courage to suggest the real solution which are tax increases to reduce the deficit and not rely on this kind of—it would be a kind of accounting slight of hand is what it would be.

Dr. **Schultze**. I think there is a distinction you could make that right now one, possibly at least it might make sense, to explain, explain any tax increase in terms of the fact that we have embarked upon making good some underfunding in the Defense Department.

Therefore, we need a tax increase to do it. That is one thing, and I think that makes sense perhaps. The other side of it say we are not going to have an earmarked trust fund for the Defense Department.

You run into all kinds of problems. The first thing you know the Defense Department is going to claim that particular little kitty is all their own.

They do not have to come back to the appropriations or authorizations committee for the money.

Senator EXON. I had that time and time again in State government. Everytime you earmark something. That is our money.

Dr. SCHULTZE. That is our money, exactly. Highways.

BALANCE INCOME WITH OUTGO

Senator EXON. OK. Thank you for coming. I really appreciated your generous input. I guess we do not weigh it often enough, because you economists think it is oversimplified but I guess the bottom line situation still is if we ever are going to get our economy straightened out, we have to get back to the dual situation of balancing income with outgo.

And if we are going to spend money, we are going to have to tax for it, and we tend to get away from that a little too often, I think.

Thank you, Mr. Chairman.

Chairman DOMENICI. I do want to add for the record that while I indicated my concurrence with the overall notions both of you expressed, that in no way changes my approach to yours, Dr. Santow, which I understand your theory.

I do agree that if we were able to put $150 to $200 billion budget side—the expenditure side reduction package together to be followed by an agreement on some tax increases which would dramatically reduce the deficit, I think the arguments are pretty persuasive that you would have to have a cautiously less stringent monetary policy, as good a commitment as you get for it or I think you run into somewhat of a course.

Perhaps Dr. Penner does not agree or does.

Dr. PENNER. I guess I do not, Mr. Chairman, because I worry very much about the last point that Charlie made. I certainly would not sit here and claim that there is something magic about the 5.5-percent upper bound of the Fed target in the abstract.

But unfortunately, we have conveyed so much magic to it that any relaxation could be interpreted by the marketplace as a reversal of policy.

Chairman DOMENICI. Yes, sir.

Dr. PENNER. As only, in fact, the first step back of many steps back. I think if you look at the numbers the Fed targets would allow for a nominal growth of about 9 percent.

All forecasts for 1982 are below that so there is no constraint there. There would be very, very little constraint, in my judgment, through 1983. In saying that, I am assuming inflation comes down significantly and Charlie may differ on that point.

If the inflation rate comes down faster than in the CBO assumptions—and I think it may, in fact—then the restraint implied by monetary policy on real growth is not very severe at all.

GREAT FEAR OF RECESSION GETTING MORE SERIOUS

Chairman DOMENICI. Let me make sure that my position is understood. I think there is a great fear out there that this recession is going to get serious enough.

We are not going to cut the deficit. They are going to loosen the money to monetarize the debt. I think that is one of the assumptions out there that is bothering the money markets enormously.

The word in mind is $200 billion credible reduction. Now, we may never be able to build that because we do not have multiyear budgeting in the real sense.

I would in no way disagree with you at all if we have a 1-year restraint and some targets. I think we are in the other part where the assumption that you would monetize that kind of debt which is going to grow once we get out of the crisis, I think that would prevail, and we would be back in high interest rates very quickly.

So I do not think we disagree in principle.

Thank you very much.

We stand in recess.

[Whereupon, at 12:05 p.m., the committee adjourned at the call of the Chair.]

STATEMENT OF JAMES R. CAPRA, SENIOR ECONOMIST FOR FISCAL ANALYSIS, FEDERAL RESERVE BANK OF NEW YORK*

Mr. Chairman and members of the Committee, I appreciate the opportunity to share with you my views on the budget outlook in general and in particular on budget estimates for fiscal years 1982-1985. Earlier you heard testimony from Alice Rivlin on the CBO reestimates of the cost of the Administration's budget proposal. I have been asked by the Committee to comment on those reestimates and on the risks of an even greater erosion in the deficit situation. I will confine my remarks to those topics.

The Importance of Accurate Budget Estimates

The President's budget includes among its primary objectives the steady reduction of the growth of federal spending and a narrowing of the federal budget deficit over the 1983-1985 time period. This Committee's actions last year and, in fact, the historical record of the Committee's actions over the past four years suggest that a sizable majority of the Committee supports these goals. However, efforts to slow down the growth in spending and reduce the deficit may fall short unless the Committee has an accurate picture of how fast spending and revenues would grow under current policies, the Administration's budget proposal, or any other budget alternative. For example, the CBO reestimates state that the budget deficit would steadily rise under the Administration's proposal. If the Committee believes that these represent the most accurate estimates available, then the task faced by the Congress is much larger than originally thought.

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* The views expressed are my own and are not necessarily those of the Federal Reserve Bank of New York or the Federal Reserve System.

Unfortunately the time lags inherent in data reporting and in the formulation, enactment, and implementation of changes in spending policies make it impossible to wait until the next fiscal year is underway before deciding on what budget estimates to use for that year. At some point during its upcoming deliberations, the Committee will have to decide on which estimates to use for fiscal years 1983-1985. It's important to recognize that given the differences in the estimates, that decision will have serious implications for the policy actions the Committee will recommend and for whether or not its ultimate objectives are achieved. My purpose here today is to attempt to shed some light on the budget estimates issue.

Technical Reestimates for 1983-1985

The CBO reestimates of the President's budget mean that in its view the estimated deficits that would result from enactment and implementation of all the policy proposals contained in the budget would be $29 billion more than shown in the budget document for 1983, $46 billion more for 1984, and $68 billion more for 1985. If the reestimates are correct, the Congress would have to enact deficit reducing measures well in excess of those proposed in the budget in order to achieve the Administration's goal of a deficit that declines to about $70 billion by 1985.

An important aspect of the CBO analysis, especially for 1983, is that the major part of the reestimates are not because of the usual differences between economists on the economic outlook. As shown below, only $4 billion of the $29 billion reestimate for 1983 is because of differences in economic assumptions. The importance of economic assumptions increases in the 1984 and 1985 reestimates--which I will discuss later; nevertheless, technical reestimates still comprise almost two-thirds of the estimating differences, even for those years.

Table 1

Increases in Projected Deficits Because of CBO Reestimates
By fiscal year, in billions of dollars

Year	Total Increase	Cause Economic Assumptions	Technical Factors
1983	29.1	4.0	25.1
1984	46.0	10.8	35.2
1985	67.7	29.2	38.5

What are these technical reestimates? First of all, they are primarily reestimates to outlays, especially for fiscal year 1983. As shown below, $20 billion of the $25 billion in technical reestimates for that year are on the outlay side of the budget.

Table 2

Composition of Technical Reestimates
By fiscal year, in billions of dollars

Year	Outlays	Revenues*
1983	19.9	5.2
1984	22.1	13.0
1985	23.0	15.6

* Figures reflect increase in deficit caused by lower estimated tax collections.

The CBO technical reestimates to outlays are concentrated in just a few accounts or programs, rather than spread across hundreds of accounts throughout the budget. In contrast to prior practice, CBO has apparently chosen to ignore small differences in spendout rates and concentrate primarily on major problem areas. I personally have some concern that that this approach could fail to uncover systematic estimating bias that would appear to be small for individual accounts but could be significant for the budget as a whole (as occurred in 1977). Nevertheless such a procedure makes it easier to evaluate the reestimates. The largest reestimates for 1983 are for farm price supports ($5.6 billion) where CBO has taken into account more recent information on crop yields and prices, offshore oil receipts ($5.2 billion) where the Administration had projected a doubling of receipts, national defense ($1.8 billion) where historical spending rates suggest a more rapid spendout of available funds than shown in the budget document, and net interest ($3.7 billion) where the costs of servicing the higher debt levels implied by the technical reestimates result in higher outlays.

The CBO technical reestimates to revenues are primarily because of higher estimates of the revenue loss attributable to the Economic Recovery Tax Act. CBO apparently believes that the normal lag between a change in business tax liabilities and tax collections will be shortened as a result of the enactment of the Accelerated Cost Recovery System. For individual income taxes, CBO is using a time series model that for a number of reasons yields somewhat greater revenue losses from the accross the board rate cuts.

Evaluating Differing Technical Reestimates

It might be argued that the technical reestimate issue is simply a disagreement among experts, and that there is no obvious criteria for determining which set of estimates is correct. Also, neither Dr. Rivlin nor Budget Director Stockman have attributed the rise in the 1982 deficit estimates to technical factors. Thus it may be argued that technical factors will not affect the 1983-85 budget deficits either. However, as the Committee considers the differences between the Administration and CBO estimates, I believe it may wish to consider the following analysis.

Over the past few weeks, my colleagues and I at the New York Fed have done an intensive review of the budget document itself, account level budget backup materials, and more recently the CBO reestimates. Our purpose has been to form our own staff estimate of the likely cost of the President's budget proposal. The results of that analysis indicate a broad measure of agreement with the CBO technical reestimates. There are some areas of minor disagreement. For example, it appears that both CBO and the Administration include an overestimate of net interest outlays of about $700 million that is the result of an accounting problem that attributes more intragovernmental interest payments by Treasury to on-budget federal agencies than the estimated offsetting intragovernmental receipts to be received by these agencies. On balance, however, our review suggests that the CBO technical reestimates may in fact understate slightly the cost of the Administration's budget program, as shown in Table 3. However, the differences are relatively small given the sixe of the projected deficits.

Table 3

Technical Changes to CBO Reestimate of the President's Budget
By fiscal years, in millions of dollars

Function	Program	1983	1984	1985
300	Water and Conservation	+161	+295	+290
370	Mortgage Credit and Thrift Insurance	+500	+500	+500
400	Surface Transportation	+450	+200	-
450	Disaster Assistance	+250	+300	-
	Community Development Grants	+400	+300	-
550	Medicare Administration	+100	+100	+100
	Medicare Unallocated Savings*	-	+1,950	+4,000
900	Intragovernmental Interest	-700	-700	-700
920	Waste, Fraud, and Abuse*	+1,000	+1,000	+1,000
	Debt Collection*	+500	+500	+1,000
950	Offshore Oil Sales	+800	-	-
	Sales of Surplus Property*	+1,000	+3,000	+2,000
Total Outlay Change		+4,461	+7,445	+8,190

* These are management savings items. The management savings estimated depended on the specificity of the plan and the existence of or commitment of funds to the creation of mechanisms for implementing the plan.

	1983	1984	1985
Total Revenue Change (Miscellaneous Receipts)	+1,500	+600	-200
Deficit Increase Above CBO Reestimate	3.0	6.8	8.4

The assertion that the rise in the deficit for fiscal year 1982 is because of economic not technical factors appears plausible on the surface and casts some doubt on whether the technical estimating problems raised by CBO and by our own analysis could actually be very large. For example, Budget Director Stockman, in earlier testimony, stated that economic changes since last year's forecast have added $55 billion to the deficit--a figure almost identical to our own estimate of $56 billion. Since the Administration's estimate last year of the fiscal year 1982 deficit was $45 billion, this would appear to account for the rise in the 1982 deficit to the $100 billion range. However, upon further reflection, there is a problem with this explanation. In particular, it ignores some of the deficit reducing actions taken by the Congress last summer and in the fall. For example, the March, 1981 budget proposed a $54 billion tax cut while the Congress enacted a $38 billion tax cut. It might be argued that the Reconciliation Act fell short of the spending cuts proposed in March. However, no one has yet been able to determine if that is in fact the case since Congress and the Administration were keeping score on different bases. Also, the Congress enacted some of the Administration's September budget reduction proposals in the continuing resolution in December.

In order to better understand why the 1982 deficit has risen from $45 billion--as estimated by the Administration in March of 1981--to $111 billion as estimated by CBO in March of 1982, my colleagues and I did an account by account comparison of the March 1981 budget to the current estimates. We attempted to sort out policy changes from changes due to the deterioration in the economy and changes due to technical factors or estimating errors. As shown below, we believe that economic factors pushed the deficit up by $56 billion. Policy changes were an offsetting factor, reducing the deficit by over $18 billion. Technical factors and reestimates increased the deficit estimate by over $28 billion. The largest component of the increase is farm price supports, where estimated outlays have risen by $8-$10 billion.

Table 4

Composition of Increase in 1982 Deficit
In billions of dollars

	Amount	
Outlays		
Economic Factors	+21.5	
Unemployment		+7.3
Inflation		-1.2
Interest**		+15.4
Policy Changes	-5.3	
Technical Factors	+31.5	
Revenue*		
Economic Factors	+34.5	
Policy Changes	-13.1	
Technical Factors	-3.0	

* A "+" means a decrease in revenues and an increase in the deficit.

** Effect of higher interest rates and the cost of servicing the larger debt attributable to economic changes.

Reestimates Due to Economic Factors

The CBO reestimates to the 1983 deficit because of economic factors are small ($4 billion) since the CBO and Administration economic forecasts for 1982 and 1983 are quite similar. In 1984 and 1985, greater differences in economic assumptions lead to larger reestimates ($10.8 billion and $29.2 billion respectively). Our analysis reveals that the budget reestimates made by CBO because of differences in economic assumptions are consistent with what is generally accepted as the sensitivity of the budget to changes in the conomy. Consequently, if the Committee chooses to use the CBO economic assumptions, it would appear to be appropriate to also use the economically driven reestimates. I will not comment on the economic forecasts for 1982 and 1983 since the differences between CBO and the Administration are quite small. For 1984 and 1985, however, I believe some clarification is needed and I would like to suggest some general criteria for the Committee when evaluating the so-called "outyear" economic assumptions.

It's important to emphasize that the assumptions for 1984 and 1985 are qualitatively different from those for 1982 and 1983. The near term economic assumptions are a forecast, by the Administration and CBO, of what the economy will look like over the next 7 quarters under a given set of fiscal and monetary policies and under the assumption of no unexpected external shocks such as a disruption in the oil market. In short, the near term forecast represents a prediction. The longer range economic assumptions (1984-1987) are simply that--assumptions. They do not represent anyone's prediction. This is exemplified by the fact that the near term forecasts for GNP by the Administration and CBO are built from forecasts of components of aggregate demand such as consumption, investment, and so forth. The outyear assumptions contain no such backup. There is no way of determining whether the assumptions reflect projections of future trends or future goals.

A degree of arbitrariness in the long range economic assumptions is understandable since more than several quarters out the uncertainties are so great that trying to predict cyclical fluctuations would probably be a fruitless and highly inaccurate exercise. This doesn't mean that the long range assumptions are unimportant. To the contrary, this Committee has had a longstanding commitment to multiyear budget targeting and long range deficit reduction. The multiyear aspects of Committee decisions are highly dependant on the long range economic assumptions. Unfortunately, the arbitrary character of the long range assumptions carries a danger for the budget process. There are natural temptations to use very optimistic long range assumptions in order to reduce the number of recommended restrictive fiscal policy measures needed to bring down the outyear deficit. In a recent article, Rudolph Penner put it this way.

> The incentives for optimism are particularly strong when making long-run budget projections. There, politicians feel unconstrained by the consensus forecast coming from economists because no one really knows what will happen in the long run. Although the fact that the new process required five-year projections of budget totals and should have enhanced the rationality of decision making, it is clear that long-run planning based on bad assumptions may be worse than not having long-run planning at all.

To demonstrate the problem, I would like to have the Committee recall the First Budget Resolution for 1980, which the Committee marked up in the spring of 1979. As a result of the Long Amendment to the Public Debt Limit Act, the Committee was ordered to report a budget resolution showing balance by fiscal year 1982. The resolution that was reported assumed policies that in many ways resemble the policies that have been adopted. The resolution assumed a large tax cut for 1982 ($55 billion) and substantial nondefense outlay cuts. The 1982 budget showed a $700 million surplus. There are many reasons why the 1982 deficit is turning out to be about $100 billion rather than in surplus. One factor is that for the outyears (1981 and 1982) the Committee assumed real GNP growth would be about 4.5 percent per year. This would have meant seven years of uninterrupted recovery from the 1974-1975 recession. If the Committee had assumed that the five year average annual growth rate (1977-1982) would be 3 percent--roughly the average for five year periods in the Seventies--the growth rates assumed for the outyears of 1981 and 1982 would have been 2.8 percent. (I am assuming no change from the Committee's forecast for 1979 and 1980.) We have calculated that under these circumstances, the 1982 budget would have been projected to have a $30 billion deficit.[1/] With such a projection, the Committee may have recommended more deficit reducing measures or would have at least had a more realistic view of the long range budget outlook.

Returning to current situation, I believe the Committee should seriously consider using long range economic assumptions for 1984-1987 that imply a growth rate for the five year period (1982-1987) that is consisten with

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1. Clearly many factors contributed to the growth in the deficit including high interest rates, a change in defense policy and higher than anticipated inflation which pushed up both revenues and outlays.

historical experience over the past ten to fifteen years. The long range assumptions would not have to include predictions of year to year cyclical fluctuations but would, nevertheless, reflect the fact that such fluctuations may on average limit outyear economic growth. If the Committee were to use 3 percent for the five year period, then the average growth for 1984-1987 (assuming no change in the CBO and Administration forecasts for 1983) would be about 2.7 percent. This rate of economic growth is lower than that contained in either the CBO or Administration long range assumptions and by our calculations would add about $20 billion to the $29 billion in CBO economically driven reestimates for 1985. This approach to outyear economic assumptions--which resembles a proposal made by Dr. Penner--would mean that combined with the CBO technical reestimates the Committee would have to rocommend almost $90 billion more in deficit reducing measures than those in the President's budget in order to reach the Administration's 1985 deficit target of $71 billion.

Additional Risks

Despite the substantial upward reestimates to projected deficits by CBO, there still remain some substantial risks that the deficit outlook could deteriorate further--putting aside the policy risk that no substantial deficit reducing measures will be enacted.

For one thing, the economy will not perform as assumed. In the CBO analysis, an attempt was made to quantify the budgetary effects of a pessimistic economic scenario. Under their more pessimistic scenario, the projected 1983 budget deficits under the Administration's budget plan would be $132 billion rather than the baseline CBO reestimate of the President's budget of $121 billion. The 1985 deficit would rise to $184 billion, rather than the baseline reestimate of $140 billion. I think that it is important to make clear, however, that the pessimistic CBO economic scenario should be viewed as pessimistic from an economic standpoint, in that it contains lower real growth and higher inflation than their baseline economic assumptions, but is not quite as pessimistic as it might be from a budgetary standpoint. But, bear in mind that the pessimistic assumption of higher inflation carries with it, from a budgetary point of view, the relatively "optimistic" result of about $20 billion more in revenues in 1985 than would have been the case under the baseline assumptions. A more likely inflation scenario under the pessimistic real growth path would be for less inflation than in the baseline. This would drive the reestimated deficit for 1985 well over $200 billion. Thus, from the standpoint of deficit reduction the risks may be somewhat greater than suggested by CBO.

Another area of risk is cost growth in national defense. For each of the past three years CBO has documented how unexpected increases in the unit prices for weapons have eroded the purchasing power of defense appropriation. Also, recent Department of Defense studies has documented the fact that the annual unexpected growth in unit costs for major weapon systems since 1975 has averaged about 3.5 percent.[2/] This implies that the President's budget for 1983-1985 may not be sufficient to purchase the weapon systems that are being proposed unless there is a significant change in that relationship.

Conclusion

In conclusion, it is apparent that the Committee faces a major task in its efforts to reduce projected deficits. The analysis done by my colleagues and myself suggests that the deficit reduction measures required to

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2. Milton A. Margolis, "Improving Cost Estimating in the Department of Defense", CONCEPTS, vol. 4, no. 2 (Spring 1981) p.8. and Stephen Gross, "Program Cost Growth in the Department of Defense as of December 31, 1980".

bring projected 1983-1985 deficits down to the levels contained in the budget document are larger than those proposed by the Administration. I would recommend that the Committee give serious consideration to technical reestimates before beginning its markup and to avoid using what could turn out to be overly optimistic long range economic assumptions. If not, the Committee may end up having made a number of difficult decisions in order to reduce future deficits only to find out later that it fell short of its goal because estimates have increased in the meantime. And if upward reestimates of the deficit are assumed as part of the markup and they prove to be pessimistic, it will only mean the Committee's actions will bring the deficits down more rapidly.

VIEWS OF THE JOINT ECONOMIC COMMITTEE

MONDAY, MARCH 15, 1982

U.S. Senate,
Committee on the Budget,
Washington, D.C.

The committee met, pursuant to notice, in room 6202, Dirksen Senate Office Building, commencing at 1:52 p.m., Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Kasten, and Gorton.

Staff present: Stephen Bell, staff director; Gail Fosler, chief economist; Lizabeth Tankersley, minority staff director; and Kemble Stokes, chief economist for the minority.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Chairman Domenici. This hearing will please come to order.

The Joint Economic Committee is required under the Budget Act to provide the Budget Committee with the recommendations for fiscal policy.[1] In the past, these recommendations have been helpful to the deliberations of the Budget Committee. Today, I want to welcome the chairman of the Joint Economic Committee, Mr. Reuss. I understand that Senator Jepsen could not be with us this afternoon, but I welcome in his place, Representative Rousselot who will discuss the views of the Republican members of the committee.

FISCAL POLICY PERPLEXING

I must be very honest, Chairman Reuss. I appreciate the concern expressed in your report for monetary policy, but I am perplexed on the committee's position on fiscal policy. The committee clearly indicates that interest rates must be reduced, which is a view that we all share. However, it also suggests that we do not reduce Federal spending further for the coming fiscal year, and that instead, we defer the 1981 tax cut.

I will submit to you, Mr. Chairman, that if we followed this recommendation, the fiscal year 1983 deficit would be $147 billion instead of the $157 billion currently projected by CBO. Budget deficits of these levels I do not feel are consistent with lower interest rates, nor with more moderate monetary policy if we are to continue to bring inflation down I believe that the budget problem we face goes far beyond the issue, single issue, of tax cuts, to the very structure of the budget and that the budget deficits have to be reduced materially, that a credible path toward balance must be enacted into law, and that on the basis of fairness and economic good sense that every part of the Federal budget must bear scrutiny.

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[1] See "The 1982 Joint Economic Committee Report" (H. Rept. 97-436).

If the views of the Joint Economic Committee disagree with my own, I hope you will be very clear about the reasons, and I am sure they will and you will, Mr. Chairman. The choices that this committee and, indeed, the Congress face over the next few months I consider to be of historic significance for the stability of our Nation's economy and I look forward to the JEC's views on how best this committee can aid the Congress in making these choices.

Now we have two Senators here. Does the other Senator want to make any opening comments?

Senator **Kasten**. Not at this time, Mr. Chairman.

Senator **Gorton**. No.

Chairman **Domenici**. Thank you.

We welcome you, Mr. Reuss. You may proceed.

STATEMENT OF HON. HENRY S. REUSS, CHAIRMAN, CONGRESSIONAL JOINT ECONOMIC COMMITTEE, AND A U.S. CONGRESSMAN FROM THE STATE OF WISCONSIN

Mr. **Reuss**. Thank you. I appreciate this opportunity. After I present the views of the committee's Democrats, my friend and colleague, Congressman Rousselot, will do the same for the Republican members.

I am particularly delighted to have this opportunity because, from the Chair's opening statement, we have not made our position clear and we will.

BUDGET PROCESS FRACTURED

The country is in trouble. I commend you, Mr Chairman, and members of your committee, for your zeal in wanting to get out and get out in a timely fashion a good budget resolution. There are those who say that the budget process is fractured. I think that would be a tragedy. I think this is the year in which we have to assume leadership. We do so at a time when the country is in trouble. The Dow Jones is off again today to 795. Interest rates are up. Unemployment and bankruptcies are tearing us apart, and the course immediately ahead for the next few weeks is a minefield of dangers.

As I have said, we have got to respect the budget process, There is also the debt ceiling limitation that lies ahead; while it is technically separate, of course it is related to what we are doing. Already Republican freshmen in the House have expressed their unwillingness to vote for an increase in the debt ceiling. And I regret to say that there are some Democrats who are saying: Why should we pull the administration's chestnuts out of the fire?

The country could grind to a halt in May, and that is a possibility so horrendous that I do not think we should even consider it. So the drama has got to unfold in the weeks between now and mid-May. We know the actors: your House and ours, your party and mine, a President locked into this program and a central bank bent on overtightening the money supply.

Is there a way out? I believe there is. That way is to have the U.S. Congress, on a bicameral and bipartisan basis, come to the rescue of the Nations' beleaguered economy. It would be nice if we could negotiate something with the President. But given his intransigence on the military budget and on the tax program, I do not see how it is going to be possible to do that. It would be nice if we could negotiate an accord with the Federal Reserve that said, look, if we reduce the deficit, will you see that the monetary aggregates respond so that interest rates come down? But this is not just a matter of negotiating with the gentle Mr. Volcker. It is negotiating with the 12-person Open Market Committee and, from all that one has been able to deduce of their views, they would seek to balance the budget by remorseless cuts out of social spending and a giant sales tax on the average American. So I do not see any prospect there.

CONGRESSIONAL DO-IT-YOURSELF PROGRAM

But there is a way out. The way I suggest is a congressional do-it-yourself program, specifically in the budget resolution. There should be four parts to such a program:

One, reduce the increase in military spending to no more than 5 percent per year in real terms. That is about one-half the rate of increase which the President seeks and would produce marked budgetary savings.

Incidentally, Mr. Chairman, you have yourself espoused that portion of the program and I commend you for it and many others on this committee, including Senator Hollings, for their position.

Two, hold nonmilitary spending to 1982 levels in real terms. Now, that means no Democratic monster public works program or the other budget-busters and, equally, it means that the effect on the needy and on the beneficiaries of the reduced 1982 and 1983 programs would not be worsened.

Third, repeal the July 1, 1983 10-percent income tax reduction. That would yield on an annual basis $40 billion a year off the deficit. I know that to repeal it is dear to the heart of President Reagan but the fact is that it is the only way to make important decreases in the budget deficit. If it were attached, as I believe it should be, to the debt ceiling legislation, I believe that debt ceiling legislation could pass both bodies. I do not believe that the President would want to plunge the country into darkness in mid-May by vetoing such a package deal, particularly when the Congress would have made clear that there would be no second choice.

The fourth and last component of the four-point package would be a directive to the Federal Reserve under our constitutional powers, article 1, section 8, "to coin money and regulate the value thereof," that the Federal Reserve not vitiate the progress toward budget balance by goosing up interest rates once again.

MONETARY POLICY

Here a little word on monetary policy is perhaps in order. Under the Reagan program of February 1981, a year ago, agreed to by the Federal Reserve and by the Congress and everybody else, the money supply, M_1, was supposed to have its growth rate reduced over the period 1981 to 1986 slowly and steadily, so that by 1986 it would be at 3.7 percent, one-half of what it was in 1980. That would have meant for 1981 a 6.7 percent growth rate. But instead the Fed got years ahead of itself and offered up a miserable, inadequate recession abetting 2.3 percent growth rate in 1981.

Then, to make matters worse, having established a low fourth-quarter 1981 base for 1982, they reduced the target to a totally inadequate 2½ to 5½ percent for 1982.

Finally, to make matters even worse, in this, the first quarter of 1982, which is now almost over, in which they were supposed to create 2½ to 5½ percent new money, they have been creating it at two to three times the upper limit of that range. That is as if a person with a weakness for alcohol promises his wife he will only spend $120 at a rate of $10 a month for booze in 1982, and when the first quarter is over, he has spent about one-half of that already and is still going strong. Thus, in order to stay within the targets, the Federal Reserve is going to have to be excruciatingly parsimonious from here on out. That is why the markets, seeing what is going to have to happen if the Fed is an honest woman, are now reacting by raising interest rates long term and short term across the board.

So in the resolution that we think should be included under the budget resolution, we, and this is set forth on page 11 of my prepared statement,[1] simply ask the Fed to adjust its 5½ and 2½ percent monetary target so as to permit interest rates to fall. We do not tell them how much. We simply have said you laced yourself, with administration help, into an impossible corset. Loosen up the whale bone a little bit before you choke.

That four-point program, we gave to Data Resources, the same outfit that does the administration's studies, and we said, and this is contained in the annex to my prepared statement,[2] run through the Reagan program and run through ours with four differences: One, we do the Domenici 5-percent military increase; two, we make no real increase in domestic spending; three, we repeal the 1983 10-percent income tax; and four 'we get the Federal Reserve out of its super tight money corset.

What did that do? Well, it does great and wonderful things in 1983. For example, this alternative gives us 7.4 percent real growth in 1983.

NO FURTHER CUTS IN CIVILIAN SPENDING BELOW 1982 LEVELS

Chairman **Domenici**. Mr. Chairman, could I ask you a question? With reference to a—and I hate to interrupt but I have to chair an Energy Research Subcommittee and I am going to leave Senator Kasten in charge. But I want to clarify one thing.

On page 12, in your prepared statement,[3] you outlined the 4 points. I believe I understand 1, 3 and subject to the obvious interpretation, I think I understand 4. But what does "no further cuts in civilian spending below 1982" mean with reference to entitlement programs?

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[1] See p. 523.
[2] See p. 527.
[3] See p. 524.

Mr. REUSS. It means no change in existing policy on entitlements. If the Budget Committee decided that an attack on certain inadequacies in the entitlements program, particularly with respect to the calculation of indices, was in order, I personally would applaud that. I am not here today to suggest to the Budget Committee how it should deal with the internals of that domestic spending. We recommend that, overall, you allow for inflation but not for real spending increases.

Chairman DOMENICI. But, Mr. Chairman, to be consistent and to plug this into an economic econometric model, you either are going to save some money from the entitlement programs or not and I understand you to be saying you are freezing the discretionary appropriations at 1982 and you would have no further cuts there, which I then assume you would assume current law for the entitlement programs because you are using us but you are not taking into consideration *x* billions of savings. You are just saying it is good to look at and it is not plugged in?

Mr. REUSS. All we plugged in was the macroeconomic figures which includes discretionary and nondiscretionary spending. I will—it includes both, Mr. Chairman, and it also includes the President's revenue-raising figures. But that does not mean that you, the Budget Committee, have to do it just that way. We simply wanted to project a work out which shows marked deficit improvement. We get the deficits down to $38 billion in 1984 and we think to a balanced budget in 1985, though that is off the radar screen. We immeasurably improve unemployment, housing starts, and housing sales. We bring the prime rate down 3 points which helps on the deficit. So that I do not conceive our Joint Economic Committee function, Mr. Chairman, to come in and say we wish you would put more into job training and we wish you would leave the social security indexing just as it is with no change in the housing component. We think that would be impertinent of us.

What we did was say take 1982 total spending, adjust for the deflator, and we will stay with that in increases except for that adjustment.

Chairman DOMENICI. Well, let me make sure that I understand then. That statement of no further cuts in civilian spending below the 1982 levels in real dollar terms, you are saying, with reference to entitlement programs that are automatically indexed, that you would add to them the deflator and no more?

Mr. REUSS. No. The deflator applies to nonmilitary spending overall. I would defer to the committee in whether it does something with entitlement programs or whether it concentrates solely on the so-called discretionary. It can do either.

Chairman DOMENICI. But that is a huge difference and I do not mean to be argumentative. I am just interested in what you asked the econometric modelers to do. If you really said nondefense accounts of this country, entitlement and appropriated, will increase to the extent of—as a composite, to the extent of the plus deflator and no more, that is one thing. If you are saying that, then we can quickly find out how many billions you are asking us to restrain. Is that what you are saying?

Mr. REUSS. That is not precisely what we are saying. The language you refer to says "no further cuts." We also say, and said earlier, "and no increases." These apply to appropriated accounts. We made no change in entitlements policy, which meant a real rise in entitlements spending of about 1.8 percent. But this is more than offset by a decline in net interest, so that total nonmilitary real spending falls by 0.9 percent.

ENTITLEMENTS NEED TO BE CHANGED

Chairman DOMENICI. Because if we do not change the entitlements in some way, and nobody is trying to put you on the spot, but obviously if you do not do something with entitlements, I think it is a composite, they are growing at more than 10 percent under current law, some CPI only, some CPI plus more, medicare and medicaid, as examples. You would be pulling those down or you would be pulling the discretionary accounts down tremendously to arrive at that dollar figure.

Mr. REUSS. Precisely.

Chairman DOMENICI. You are saying, that is up to someone else but that is what you recommend?

Mr. REUSS. Well, this is not buck passing but properly we do not think we should come in and do the exercise that so many of your good Members are doing.

I just conclude then, Mr Chairman, in saying here is an opportunity for Congress not to ask or beg or exhort the Federal Reserve and the administration. Congress has its constitutional duty. I would hope that we could do it. I would hope that we could get the kind of program and the kind of results that our Data Resources printout indicates are possible and I would confidently predict that it would have the most wholesome affect on the economy and the markets.

Chairman DOMENICI. Before you would leave, and Congressman Rousselot, I hope you would understand, I am going to ask the staff, and maybe they can before you leave, just for the record—but I am going to make a wild guess that you are recommending more fiscal restraint aside from defense, you are recommending more than the President in 1983. I am not sure of that but it would seem to me you are recommending significantly more than he is in restraint.

Mr. REUSS. We think not but we will be glad to go over it with the staff.

Chairman DOMENICI. Thank you, Mr. Reuss.

PREPARED STATEMENT OF HON. HENRY S. REUSS, CHAIRMAN, CONGRESSIONAL JOINT ECONOMIC COMMITTEE, AND A U.S. CONGRESSMAN FROM THE STATE OF WISCONSIN

I thank you for the opportunity to appear before the Senate Budget Committee pursuant to the Budget Act, which requires such testimony on the part of the Chairman of the Joint Economic Committee.

This country is in trouble. High interest rates, recession, unemployment, and bankruptcies are tearing us apart at home and eroding our position in the world. I am not one of those who sees a depression just around the corner. But I do see a destructive period of stagnation ahead, unless we change our course.

And on the course immediately ahead, there is a veritable mine field of dangers. The first budget resolution must be approved not later than May 15. Already there is talk that that budget resolution is an impossibility. Such a result, which would mean the end of the budget process, would be a tragedy.

Equally imminent is necessary Congressional action on an increase in the debt ceiling, already over a trillion dollars. That ceiling will be reached in early May. Already freshmen Republicans in the House are announcing their unwillingness to vote for an increase in the debt ceiling. Already Democrats in both bodies are wondering why they should undertake an unpopular vote to pierce the ceiling, with its implied endorsement of the deficits in the

Reagan budget.

Failure to have a bi-partisan budget resolution in place by early May would court an extraordinary peril. In the absence of a bi-partisan alternative to the Reagan budget and its multi-hundred billion dollar deficits, a resolution to extend the debt ceiling will become a referendum on the economic performance of the Administration. I need not tell you that in such a referendem the Administration will fail. Today, Democrats and Republicans alike recoil from the harsh civilian spending cuts, the extravagant waste of money on defense, the intransigence on taxes, from the deficits, and above all from the manifest economic failure of the President's program. Few Members from either party would stand up to be counted in favor of the Reagan deficits on such a vote.

Thus the great drama before us must unfold to its conclusion in a matter of weeks -- between now and the middle of May. The actors in the great drama are all identified -- the two Houses of Congress, the two great parties, a President locked into his program and unwilling to give an inch, and a central bank bent on over-tightening money no matter what the cost in human misery.

Is there a way out?

I believe there is. It is the United States Congress -- Senate and House, Republicans and Democrats -- which must come to the rescue of the Nation's beleaguered economy, and must do so within the next sixty days. It would be nice if the President and the Federal Reserve were willing to enter into a fair compact with the Congress. But the clock is running, and we cannot wait.

Let us not ask Mr. Reagan how Congress shall compose its budget. Let us not ask Mr. Volcker how Congress shall exercise its Constitutional responsibility (Article I, Section 8) to "coin money, regulate the value thereof".

Let us not ask them. Let us tell them. Here is how.

In quick order, we need two pieces of legislation:

1. A First Budget Resolution, with the following four features:

   a. Repeal the July 1, 1983 ten percent income tax reduction.

   b. Increase military spending at no more than 5 percent per year in real terms -- about half the real rate of increase which the President seeks.

   c. Hold non-military spending to 1982 levels in real terms.

   d. Direct the Federal Reserve to adjust its monetary targets and so allow interest rates to fall.

2. A bill on the debt ceiling and taxes, which must originate in the House Ways and Means Committee, which provides:

   a. Whatever debt ceiling adjustment is needed to accommodate the recession-induced deficit.

   b. A repeal of the July 1, 1983 income tax reduction.

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In the present circumstances, the clear burden of compromise lies with the supporters of the President's program. The sources of our difficulties are the excesses of the program proposed by the

President and enacted by the Congress last year. This is no secret. The tax cuts were too large. The defense buildup is vast, extravagant, and wasteful. Monetary policy is too tight. To command bi-partisan support, you cannot ask the poor, working people, the middle class and the elderly to accept a greater burden of cuts, while these three facets of the Reagan program escape revision. If the President refuses to acknowledge this, then the realistic leaders of Congress on this Committee must simply sweep the President out of your way.

Let me lay out for you what I, and the Democrats on the Joint Economic Committee, believe to be the four basic realities with which your Committee must cope.

On Taxes. There is no way to escape modification of the Kemp-Roth income tax reductions. You can do it by subterfuge or you can do it directly, but you must do it. The ten percent reductions scheduled for July 1, 1982 and July 1, 1983 are the prime source of the deficit in the near future. No amount of fiddling with corporate taxes, however desirable, can close the gap opened by Kemp-Roth and indexing. Large-scale loophole-closing, however desirable on the merits, cannot be seriously proposed for immediate action. And excise or sales taxes currently under discussion in some circles are an insult to working people and will not pass.

The single most dramatic and effective action this Committee can take would be to propose the repeal of the July 1, 1983, 10 percent tax reduction. To ensure passage and to guarantee the President's signature, such a repeal should be attached to the debt ceiling legislation and both should be presented for immediate action.

Given such a guarantee of lower deficits, conservatives, moderates, and newly awakened anti-deficit liberals would support you. A major crisis in the affairs of the government would be averted. Given this prospect of fiscal responsibility and lower interest rates, the financial markets would relax. And even the President would be forced to thank you, in secret, for saving him from the worst aspects of his own folly.

On indexing, which takes effect in 1985, action may also be necessary, in order to prevent untenable budget deficits down the line.

On Military Spending. It is universally agreed, outside the Pentagon and the White House, that the military buildup proposed in the President's budget is too large and too rapid. Very few experts in national security matters argue that the size and pace of the buildup is necessary on national security grounds. Many, indeed, fear damage to national security, which may stem from initiating another cycle of feast and famine in military affairs, as this year's excess is corrected by next year's retrenchment.

On economic grounds, the pace and extent of the buildup entail dangers comparable to, and perhaps greater than, those experienced at the time of the Vietnam war. The Joint Economic Committee held a series of hearings last year on the inflationary dangers of production bottlenecks, labor shortages, and unbalanced macroeconomic policy resulting rom the current buildup. We urge that the buildup be scaled back.

By how much? In this decision, the requirements of sound military and budget policy must weigh against the need for rapid agreement. The compromise initiated by your Chairman, Senator Domenici, which would limit defense spending growth to 5 percent after inflation, is a good one. I recognize that there are those in my own Party, with great expertise on military matters, including the ranking Democrat on this Committee, Senator Hollings, who urge a tighter limit on both security and budget grounds. But agreement on a complete bi-partisan budget package ought not be held hostage to achieving a lower target than the 5 percent real growth to which Members of Congress can now readily agree.

On Civilian Spending. Congress in 1981 enacted, at the President's request, sharp cuts in discretionary social programs, in grants-in-aid to state and local governments, and in entitlements. Many Members voted for these cuts in the belief that the economy would respond to the full Reagan program with a surge of investment and growth, and so severe hardship would not result. Specifically, many cuts in programs supporting working people and the poor, including unemployment compensation, nutrition programs, Medicaid, AFDC, and labor training assistance, were enacted in belief that the demand for labor from the private sector would rise, absorbing the affected individuals in productive private sector jobs.

This of course did not happen. Those who lost CETA jobs are on the street; those who lost eligibility for Medicaid and welfare and day care and nutrition are eking out a reduced existence on the dole; and many formerly productive workers are bitterly in need of protection which our unemployment compensation program no longer provides. Fiscal distress in state and local government is also widespread. In the Congress, those who believed in the Reagan program have had their hopes dashed. Those of us who doubted have had our fears confirmed.

In ordinary times, the situation we now confront would lead to irresistible pressure to increase spending for public works and social welfare programs. I believe that, given the deficits and the need for a rapid, bi-partisan agreement, this pressure can and should be resisted, with small exceptions in the areas of extended unemployment compensation and labor training.

Further consideration of deep cuts in social spending at this time, however, would doom any prospect of bi-partisan cooperation to prevent a fiscal crisis when the debt ceiling is pierced, and would lead directly to the breakdown of the budget process. Sharp cuts in the social sector have already been made, and we cannot continue to ask that the burden be shared unfairly.

The First Budget Resolution should hold the line on discretionary social spending in real terms at 1982 levels. This would imply neither a cut nor an increase in current policy and programs. While many in my own Party would regard such a level of spending as inadequate in the face of widespread distress, I would again urge that this is an area where Democrats can compromise in the interest of rapid agreement.

On Monetary Policy. We now come to a final, and especially difficult area. It is not the habit of the Congress to address monetary policy as part of the budget process. This year, however, we must chart a new course.

Monetary policy will determine whether the program you develop in the areas of taxes and spending will succeed or fail. If interest rates fall, you will succeed; if interest rates do not fall, you will fail. Any program to control the deficit in fiscal years

1983 through 1987 must therefore be accompanied by a guarantee from the Federal Reserve that the corresponding benefit -- lower interest rates -- will come into effect at once. The only way to assure that result, in my judgment, is to write the intent of Congress in the matter of monetary policy into the First Budget Resolution itself.

The recession, and the high interest rates which are the recession's proximate cause, are not simply and solely the consequence of large prospective out-year budget deficits. They result from the interaction of those deficits with the sharply contractionary monetary policy pursued by the Federal Reserve in 1981. And if monetary policy is not corrected, curing the future deficits will be at the same time more difficult to do and far less effective.

In its Economic Recovery Program of February 18, 1981, the Administration set out a reasonable and moderate course for monetary policy from 1981 through 1986. They suggested that the growth rate of the monetary aggregates be reduced slowly from 1980 levels to one-half those levels in 1986. Since the growth rate of M1B was 7.3 percent in 1980, the Administration's original objective implied a reduction in annual money growth rates of 3.65 percentage points over six years, or a progressive reduction of about 0.6 points in money growth in each year. This was the assumption that underlay the Administration's original economic forecasts, and its fulfillment would have meant money growth averaging above 6 percent annually in 1981 and 1982.

Instead, as you know, money growth in 1981 was only 2.2 percent, well below the bottom of the Federal Reserve's target range, and about one-third what the Administration originally assumed.

This sharply reduced money growth is directly responsible for high interest rates and for the recession, both of which add hugely to the deficits, present and future.

The Administration made the mistake of supporting the sharp reduction in money growth below their original assumptions in 1981. Now they and the Federal Reserve have compounded the error, by adopting a new target range for 1982, 2.5 - 5.5 percent, whose rate of growth is lower than for 1981, and whose base, or point of departure, is the depressed level of the money stock in the fourth quarter of 1981. Now, even if the Federal Reserve hits the top of its target range in 1982, the resultant level of the money stock will be far below the Administration's own original assumptions for the end of 1982, and will be inconsistent with economic recovery and lower interest rates this year. Without economic recovery and lower interest rates, you will not begin to approach a balanced budget. Even deficits lower than the once unthinkable level of one hundred billion dollars will be beyond your grasp.

There is a simple solution to this problem. The Federal Reserve should return to the original targets for monetary policy established by the Administration, and endeavor to meet those targets on a two-year rather than an annual basis. This would require undoing, in 1982, the super-tight money inflicted on the economy in 1981; in particular it would require abandonment of the excessively restrictive 2.5 - 5.5 percent target for M1 which the Federal Open Market Committee formally adopted last month. With the targets relaxed, markets would no longer fear that the present spurt in borrowing and money creation will lead inevitably to tighter money and higher interest rates in the immediate future, and so short-term interest rates would fall. And the Federal Reserve would benefit from the greater flexibility, since the true source of current high money growth is not excess demand and purchasing power, but rather distress demand from companies to fund inventories and meet payrolls in the face of falling sales and recession.

Such a biennialization of the monetary targets would in no way imply retreat from the goal of fighting inflation. In 1982, with manufacturing capacity utilization at 70 percent and unemployment near 10 million, there can be no inflationary pressure from a more relaxed monetary policy. Indeed, as interest rates fall, the short-run inflationary pressure of interest on costs and from the federal budget deficit will subside. And, for 1983 and after, the Federal Reserve would simply return to the gradualist path prescribed in 1981 by the Administration, a path which all agreed was consistent with continued progress against inflation.

How to convey such an instruction? Section 301(a)(6) of the Budget Act specifically authorizes the Budget Resolution to include "such other matters relating to the Budget as may be appropriate to carry out the purposes of this Act." There is no additional subject more appropriate to the debate on the budget this year than the course of monetary policy. Indeed, if we do not have such language, many Members of Congress will hesitate to impose further fiscal sacrifice on their voters. We Democrats in particular are past the point of buying a pig-in-a-poke; we certainly will not buy one from the Administration, and I doubt that many Democrats will buy one from the Federal Reserve.

The First Budget Resolution is the appropriate vehicle for Congressional instruction to the Federal Reserve. Because it is a Resolution, which goes into effect on passage without benefit of Presidential signature, an instruction contained in it preserves the traditional independence of the Federal Reserve from the Executive, and the traditional dependence of the Federal Reserve on the will of the Congress. Under our Constitution and the Federal Reserve Act, we in Congress are the Federal Reserve's masters. Once a Budget Resolution embodying an instruction to the Federal Reserve went into effect, it would be binding. And, as every Chairman of the Federal Reserve Board including the incumbent has testified, it would be obeyed.

Language along the following lines would constitute an appropriate signal to the Federal Reserve.

> "The Federal Reserve shall adjust the monetary targets in effect for 1982, so as to permit interest rates to fall. Should changing economic conditions render a departure from this directive desirable, the Federal Reserve shall so report to the two Banking Committees of the Congress."

I do not offer this language lightly. It would be an unprecedented step. It is my belief, however, that if we do not act now to change the course of monetary policy as well as that of taxes and spending, we invite far greater legislative risks in the near future. The drumbeat for credit controls, for national usury laws, and for political dismemberment of the Federal Reserve System can be heard quite distinctly on the far side of Capitol Hill. If you wish to avert far-reaching, uncontrollable and perhaps irreversible action later this year, this step could bring the Federal Reserve back to its senses on monetary policy before it is too late.

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In summary, I have proposed a First Budget Resolution based on four simple and sensible guidelines, which I believe offer the hope of achieving bi-partisan support in the time remaining before we confront the debt ceiling crisis. The four steps are:

1) Repeal of the July 1, 1983 10 percent personal income tax reduction. To avert a veto, this should be attached to the debt ceiling.

2) No further cuts in civilian spending below fiscal year 1982 levels in real dollar terms.

3) Five percent real annual growth in military spending.

4) A return of monetary policy to a path of gradual deceleration from 1980 levels, involving an undoing of the super-tight monetary policy of 1981.

What, in economic terms, would such a program imply? To provide an answer to that question, we submitted these four assumptions to the econometric consulting firm of Data Resources, Incorporated, and asked them to compare an economic policy based on those assumptions, with a forecast which assumes enactment of the President's Fiscal Year 1983 budget.

The results are provided in the attached Table. They show that our alternative program would produce a rapid return of real GNP growth in 1983. It would create two million new private sector jobs next year. It would revive the housing and the automotive sectors. It would lower interest rates. It would not significantly increase inflation.

Most important, our program would cut the deficit by a third in Fiscal Year 1983, and by more than one-half in Fiscal Year 1984.

While we do not have a forecast extending further into the future, we would put the country clearly on the track toward a balanced budget -- a goal shared by one and all.

Incidentally, we let Data Resources handle its own model processing, rather than doing what the United States Treasury, to its shame, did in its attempt to discredit Senator Hollings' commendable budget initiative: the Treasury hijacked Data Resources' model, neglected to put into the computer a reasonable interest rate projection, and thus was able gleefully to pronounce Senator Hollings' brainchild dead on arrival.

This immediate action program can and should be bi-partisan. Every single one of its recommendations has been echoed repeatedly by leading Republicans and Democrats of both Houses. While there could be added to it an amendment here, a gloss there, time is of the essence, and I would hope that the two bills could be launched in their pristine form.

If they are kept simple, I am confident that they would fly.

The Budget Resolution so far as it affects military and non-military spending is a matter for the Congress, and requires no Presidential signature. Perhaps, many months from now, specific non-military appropriations would be fought out between the Congress and the President in the battle of the veto and the override. But I would not anticipate that the broad outlines of the First Budget Resolution would be drastically changed.

As to the monetary directive to the Federal Reserve, that is a matter of Congress talking to its creature, the Federal Reserve. The Federal Reserve is quite properly independent of the Administration, and the Administration has no role or function in the directive. But the Fed is responsible to the Congress.

As to the repealer of the 1983 income tax cut, I grant you that this is dear to the President's heart. It is, after all the last vestige of his supply-side fiasco. But the tax repealer would be linked from the beginning to the debt ceiling legislation. The Congress would make clear that, should the President veto such legislation, the grinding to a halt of the Nation's government and financial system would be the President's doing. The Congress should have no intention of coming back again.

This is the bi-partisan initiative I recommend. Let the Congress assume the power and the opportunity that the Constitution and the laws have given us. Let us fashion a Congressional budget, with ancillary debt legislation, that meets the Nation's needs.

The Nation is looking for bold action. It is Congress' historic opportunity. As Chairman of the Joint Economic Committee, I salute you of the Senate Budget Committee for the leadership you have already shown, and I offer you the hand of bi-cameral and bi-partisan cooperation, to pull the ox from the ditch into which it has sadly fallen.

Thank you.

TABLE

COMPARISON OF FORECASTS OF RESULTS OF REAGAN PROGRAM AND JEC ALTERNATIVE PREPARED BY DATA RESOURCES, INC.

	1982	1983	1984
Real GNP Growth (%)			
Reagan[1]	-0.7	4.3	4.0
Alternative[2]	0.5	7.4	3.9
Unemployment (%)			
Reagan	9.4	8.7	7.8
Alternative	9.2	7.3	6.3
Deficit (Fiscal Year, Billions of $)			
Reagan	109.1	100.1	93.7
Alternative	101.7	65.3	38.7
Housing Starts (Millions of Units)			
Reagan	1.2	1.6	1.7
Alternative	1.4	2.2	2.1
Auto Sales (Millions of Units)			
Reagan	8.9	10.0	10.6
Alternative	9.7	11.5	12.4
Three-Month Treasury Bill Rate (%)			
Reagan	11.8	12.0	11.4
Alternative	8.8	9.9	7.7
Consumer Price Index (% Change)			
Reagan	7.4	7.3	7.1
Alternative	7.4	8.0	8.0
Prime Interest Rate (%)			
Reagan	15.2	15.5	14.6
Alternative	12.9	12.9	11.1

1/ Data Resources, Inc., analysis of Reagan policies, February 10, 1982.

2/ Data Resources, Inc., February 22, 1982, simulation run of forecasting model.

Chairman DOMENICI. Congressman Rousselot?

Mr. ROUSSELOT. Do you wish me to begin before you have a chance to question my colleague Mr. Reuss?

Chairman DOMENICI. I think you ought to give your statement or summary and then we can have questioning.

STATEMENT OF HON. JOHN H. ROUSSELOT, MEMBER, CONGRESSIONAL JOINT ECONOMIC COMMITTEE, AND A U.S. CONGRESSMAN FROM THE STATE OF CALIFORNIA

Mr. ROUSSELOT. Thank you. As a former member of the Budget Committee in the House, I am very appreciative of the job you all have to do on this committee to sort through the vast number of dollar figures, trying to give guidance to the various authorizing committees after you have passed your budget. So I come to you not only as a member of the Joint Economic Committee but also as one who has served on the Budget Committee in the House and who knows the tremendous difficulty there is in trying to sort through all the variables in order to adopt a budget.

REPUBLICAN JEC MEMBERS CONFIDENT ABOUT ECONOMIC RECOVERY PROGRAM

The Republican members of the Joint Economic Committee are optimistic about the prospect for the national economy in 1982 and also 1983. I think our new terminology is cautiously optimistic. I think that is the new term we use about how the economy will go. We believe in the fundamental soundness of the economic program that was enacted in 1981 in this Congress, we think that direction was correct and we are confident of its success in the long range.

We do not believe economic recovery will happen overnight but we do believe that it will happen.

We reject the call for a change in direction. We clearly reject the concepts of tax increases which so many of our colleagues are calling upon now, and we are most definitely rejecting a return to the worn out Keynesian economic policies which we believe got us into the economic mess we now find ourselves in.

SPECIFIC PROGRAM RECOMMENDATIONS

And so we recommend continuation and enhancement of the economic recovery program which is already in place and let me give the specific recommendations of our Republican members of the Joint Economic Committee so carefully led by Senator Jepsen.

One, we support further efforts to reduce the Federal budget deficit by additional spending reductions and not tax increases. We do not believe that it is necessary to increase taxes to the degree that some of our colleagues are talking about with the possible exception of a few places, for example, maybe in leasing provisions.

Two, we urge comprehensive consideration of additional tax measures aimed at increasing saving, investment, and productivity and we have discussed those in our report.

And three, we think we should redouble our efforts to eliminate and reform excessively burdensome Federal regulations and several members of this committee have legislation proposed to do just that.

Four, and most importantly, we think there must be a renewed commitment by the Federal Reserve to maintain a steady, consistent, noninflationary monetary policy. In our report we have included some charts to show you we believe that policy has been erratic in the last year.

INTEREST RATE LEVEL TOO HIGH

We recognize that the economy is currently in recession, just as our Democratic colleagues do, that unemployment is rising and continued high interest rates—although I was not aware, as my colleague, Mr. Reuss, indicated that interest rates were back up—maybe he knew something from the marketplace today that I did not know. My understanding is that the prime rate came down last week very slightly, I think it was Thursday or Friday, to 16 percent.

But in any regard, we consider that level too high of an interest rate, that it does affect what the Treasury does in the marketplace, to put out debt securities, because it influences the price they have to pay for money. So we too are very conscious of that. But we think it is a lot better than it was when it was 21 percent under the Democratic administration.

LONG-RANGE ECONOMIC STRATEGY NEEDED

We believe that there must be a long-range economic strategy, to reduce inflation, to increase productivity, to improve real economic growth, also to improve international competitiveness and to increase the real standard of living.

And if there is one thing we can be certain of that is there is no quick fix or instant solution. I am terribly interested to see so many of my colleagues, especially in the House, who are instant balance the budget experts. We are delighted to have them on board but they were never there when I offered, on 11 different occasions, balance-the-budget resolutions in the House. They never voted for them. But I am delighted to see them on board.

The Republican members of the Joint Economic Committee feel that we must hold to a firm and steady economic course. We have tried to back that up with supporting statistics and charts in our report.

We supported President Reagan's rejection of economic tinkering in response to shortrun economic developments. I was pleased to see that the President decided to reaffirm many of the key elements of his economic recovery program when he presented his budget package to the Congress last month. The President believes, and we agree, that policies of economic tinkering have in the past created substantial instability, inflation, and false expectations which are the root of current economic problems.

With the severe limitations of economic forecasting, and I emphasize severe limitations of economic forecasting—by the way, it might be interesting for this committee to look back at some of the projections by economic forecasts. Even the economic projections by our own Congressional Budget Office in the past. They have not always been right on target.

We must recognize the limitations involved and that economic forecasting is not a very exact science at best. Noting the actions of economic variables outside our control, such as OPEC and a notable lack of success in secular efforts, we believe that the proper role of Government policy is to foster a climate of long-range stability and noninflationary growth. The Reagan program, and much of what we in this Congress enacted last year, meets that criteria by establishing the foundation for long-term economic growth.

DECLINE IN PRODUCTIVITY AND GNP GROWTH LOWERS LIVING STANDARDS

I think it is good for this committee and all of us in Congress to remember that President Reagan literally inherited a terrible economic hangover. I do not even think Excedrin would have helped. The President came into office with an economy that was not only moving into recession but one which had been in secular decline for some years. Our Nation's rate of real GNP growth, the most basic measure of economic well-being, has declined from a rate of 4.3 percent per year from 1959 to 1965 to 4 percent from 1965 to 1969, to 3.6 percent from 1969 to 1973 and then declined to 2.8 percent from 1973 to 1979. There has been virtually zero growth since 1979. This has been accompanied by a sharp decline in national productivity which translates directly into lower standards of living.

The written statement that we present includes tables documenting how poorly the United States has done in comparison to other industrialized countries and how the decline in productivity and GNP growth has lowered living standards.[1]

As one can see, in terms of real growth weekly earnings in these charts, and especially in terms of real spendable weekly earnings, American workers are much worse off today than they were 10 years ago.

PRESIDENT'S ECONOMIC PROGRAM DESIGNED TO ALTER BAD TRENDS

The President's economic program was designed to alter these very bad trends by increasing the reward for work, saving and investment, by reducing taxes, by eliminating regulatory barriers to production, by reducing Government's command of private sector resources and by stopping inflation. I think inflation, we all recognize, has been pretty well stopped. Inflation has come down very substantially and I do not like to bring up an old index but let us take a combination of inflation and unemployment, which I think our former President called the misery index. This index has come down very substantially since President Reagan came to power and since the Congress acted to try to respond to that misery index.

Now, the growth of Government lending has been reduced slightly, at least we stopped the growth, and Government taxes and the deficit are beginning—as a share of GNP—to decline. We must see progress in reducing the size of the Federal deficit.

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[1] See p. 540.

REDUCING SIZE OF SCHEDULED TAX REDUCTIONS OPPOSED

We strongly oppose efforts to achieve this goal by reducing the size of the scheduled tax reductions. In the first place, it would do little to accomplish the goal of reducing the deficit since the increase in budget receipts from delay of the tax cut would offset only a small fraction of the estimated deficit—this assumes current economic growth trends which would certainly be lower if the tax cut were delayed.

Second, the personal tax cut barely offsets the tax increases taking place simultaneously as a result of bracket creep and social security tax increases which my Democrat colleagues fail to take into account when they talk about tax reductions. They never talk about slowing down the social security tax increases which were put into place in 1977.

Thus, any reduction in the size of the personal income tax constitutes a significant tax increase and a serious hardship for all taxpayers, especially the 99 million working people in this country.

ADMINISTRATION'S ORIGINAL TAX REDUCTION PLAN SCALED BACK

It must be pointed out that the administration's personal tax reduction plan was significantly scaled back and delayed from what was originally presented to the Congress and many of us on the Ways and Means Committee in the House were disappointed when that compromise was made. We think that was a major tactical error on the part of Congress but that was the final compromise.

So instead of having a 20-percent tax reduction to have been in place by January 1982, there was only a 5-percent reduction starting on October 1 and yet you would think that had been in place for years by the way some of my colleagues have talked and it has not been. As a result the scale-back has effectively postponed the fully intended positive effects of the tax reduction on—in our economy.

In fact, I, along with several of my colleagues, have advocated moving up the July 1982 10-percent reduction to January of this year. Now we are realistic enough to know that our two tax writing committees do not move that fast. But we still believe such a moving up that would have an extremely stimulative effect in the economy and we think that that slow down of the tax reduction has in fact affected the economy, especially on the incentive side.

LONG-TERM ECONOMIC GROWTH ACCOMPLISHED THROUGH TAX CUTS

We know of no school of economics that argues that tax cuts ought to be increased during a recession or as a means of increasing economic growth. Yet, some of my colleagues have now called for scaling back these tax reductions. We believe that the best way to reduce the deficit is not only to encourage economic growth over the long term but also to make sure that the spending reductions that have been called for are put in place. So we think that the recently enacted tax reduction is the best means we have for accomplishing the goal of long-term economic growth. Those who propose that these significant tax cuts be taken away in the hope of using these tax increases, and that is what they are, to balance the budget, have forgotten recent experience.

From fiscal year 1976 to fiscal year 1981, the tax burden on the people of this country increased by $300 billion, representing an increase of one-third of our national debt since our country was established in 1789. What was the effect on the deficit of this doubling of the tax burden during these years? Did these increases in tax revenues help the economy? They did not. The deficits, as I have stated, total over $300 billion cumulative during the 5-year time period and the fiscal year 1981. The deficit of $57.9 billion of add-on debt was only $8.5 billion less than the fiscal year 1976 deficit.

What was the effect of this $300 billion tax increase on economic growth? Economic growth declined every year from fiscal year 1977 to fiscal year 1980 and in 1981 we had a meager 1.9 percent increase in real GNP.

To us the message is clear. If the large portion of the stimulative tax cuts, such as the removal of the third year of the tax cut, are rescinded, we can look for slower economic growth and slow down in recovery and larger deficits. The Congress must realize that even with the President's spending and tax reductions enacted last year, the U.S. Government will still spend and tax more than in any other year.

REAGAN ECONOMIC RECOVERY PROGRAM MAKING SIGNIFICANT PROGRESS

The Reagan program of economic recovery made significant progress last year but we did not slow Government spending and increased taxes down totally. As a matter of fact, we only reached the potential increase in tax revenues in 1982. They were proposed to have been $110 billion increase in revenues and we only cut that increase in tax revenues in half by our actions of last year.

In 1963 President Kennedy recognized the essential elements for a strong economy which were included in the program for economic recovery when he wrote in his then economic report:

> Only when we have removed the heavy drag our fiscal system now exerts on personal and business purchasing power and on the financial incentives for greater risk taking and personal effort can we expect to restore the high levels of employment and high rate of growth that we took for granted in the first decade after the war.

Could not have said it better myself and I think that his statement is especially applicable today.

BALANCED BUDGET

We do not defend deficits. Every Republican member of the Joint Economic Committee wants a balanced budget and as soon as we can achieve one. Many of us would probably be more drastic in our spending reductions than some of our colleagues on the other side of the aisle who are now talking about balanced budgets. The record clearly shows the Republicans on the Joint Economic Committee have for many years been concerned with the growing control over the economy by the Federal Government through higher and higher spending and higher and higher deficits. But we strongly believe that calls to balance the budget on the backs of the taxpayers are misdirected and economically unsound. Many of us, by the way, also believe, that we need as soon as possible a balanced budget constitutional amendment. So that instead of just talking about balanced budgets, Congress would be constrained to produce balanced budgets. Instead of just talking about them, they would be forced to produce them.

Thank you.

Senator **KASTEN** [presiding]. Thank you, Mr. Rousselot.

PREPARED STATEMENT OF HON. JOHN H. ROUSSELOT, MEMBER, CONGRESSIONAL JOINT ECONOMIC COMMITTEE, AND A U.S. CONGRESSMAN FROM THE STATE OF CALIFORNIA

THE REPUBLICAN MEMBERS OF THE JOINT ECONOMIC COMMITTEE ARE OPTIMISTIC ABOUT THE PROSPECTS FOR THE NATIONAL ECONOMY IN 1982. WE BELIEVE IN THE FUNDAMENTAL SOUNDNESS OF THE REAGAN ECONOMIC PROGRAM AND ARE CONFIDENT OF ITS SUCCESS. WE REJECT CALLS FOR A CHANGE IN DIRECTION, FOR TAX INCREASES, OR A RETURN TO THE WORN-OUT KEYNESIAN ECONOMIC POLICIES WHICH GOT US INTO THE CURRENT ECONOMIC MESS. WE RECOMMEND CONTINUATION AND ENHANCEMENT OF THE PROGRAM WHICH IS ALREADY IN PLACE. IN PARTICULAR, WE RECOMMEND:

1. FURTHER EFFORTS TO REDUCE THE FEDERAL BUDGET DEFICIT BY ADDITIONAL SPENDING REDUCTIONS, NOT BY TAX INCREASES;

2. CONSIDERATION OF ADDITIONAL TAX MEASURES AIMED AT INCREASING SAVING, INVESTMENT, AND PRODUCTIVITY;

3. REDOUBLED EFFORTS TO ELIMINATE AND REFORM EXCESSIVELY BURDENSOME FEDERAL REGULATIONS;

4. AND, MOST IMPORTANTLY, A RENEWED COMMITMENT BY THE FEDERAL RESERVE TO MAINTAIN A STEADY, CONSISTENT, NONINFLATIONARY MONETARY POLICY.

ALTHOUGH THE ECONOMY IS CURRENTLY IN A RECESSION, WITH UNEMPLOYMENT RISING AND CONTINUED HIGH INTEREST RATES, WE BELIEVE IT IS CRITICAL TO REMEMBER THAT THE REAGAN ECONOMIC PROGRAM WAS NOT ENACTED AS A SHORT-TERM, COUNTERCYCLICAL PROGRAM, BUT RATHER AS PART OF A LONG-RANGE STRATEGY TO REDUCE INFLATION AND INCREASE PRODUCTIVITY, REAL ECONOMIC GROWTH, INTERNATIONAL COMPETITIVENESS AND REAL STANDARDS OF LIVING. IF THERE IS ONE THING WE CAN BE CERTAIN OF, THAT IS THERE ARE NO QUICK FIXES OR INSTANT SOLUTIONS TO OUR ECONOMIC PROBLEMS. WE MUST HOLD TO A FIRM AND STEADY ECONOMIC COURSE.

WE SUPPORT PRESIDENT REAGAN'S REJECTION OF ECONOMIC TINKERING IN RESPONSE TO SHORT-RUN ECONOMIC DEVELOPMENTS. I WAS PLEASED TO SEE THAT THE PRESIDENT DECIDED TO REAFFIRM MANY OF THE KEY ELEMENTS OF HIS ECONOMIC RECOVERY PROGRAM WHEN HE PRESENTED HIS BUDGET PACKAGE TO THE CONGRESS LAST MONTH. THE PRESIDENT BELIEVES, AND WE AGREE, THAT POLICIES OF ECONOMIC TINKERING HAVE IN THE PAST CREATED INSTABILITY, INFLATION, AND FALSE EXPECTATIONS, WHICH ARE AT THE ROOT OF OUR CURRENT ECONOMIC PROBLEMS. WITH THE SEVERE LIMITATIONS OF ECONOMIC FORECASTING, THE ACTIONS OF ECONOMIC VARIABLES OUTSIDE OUR CONTROL (SUCH AS OPEC), AND THE NOTABLE LACK OF SUCCESS OF PAST COUNTERCYCLICAL EFFORTS, WE BELIEVE THAT THE PROPER ROLE OF GOVERNMENT ECONOMIC POLICY IS TO FOSTER A CLIMATE OF LONG-RUN STABILITY AND

NONINFLATIONARY GROWTH. THE REAGAN PROGRAM MEETS THESE CRITERIA BY ESTABLISHING THE FOUNDATION FOR LONG-TERM ECONOMIC GROWTH.

IT MUST BE REMEMBERED THAT PRESIDENT REAGAN LITERALLY INHERITED AN ECONOMIC HANGOVER. THE PRESIDENT CAME INTO OFFICE WITH AN ECONOMY WHICH WAS NOT ONLY MOVING INTO A RECESSION, BUT ONE WHICH HAD BEEN IN SECULAR DECLINE FOR SOME YEARS. OUR NATION'S RATE OF REAL GNP GROWTH -- THE MOST BASIC MEASURE OF ECONOMIC WELL-BEING -- HAS DECLINED FROM A RATE OF 4.3 PERCENT PER YEAR FROM 1959 TO 1965, TO 4 PERCENT FROM 1965 TO 1969, TO 3.6 PERCENT FROM 1969 TO 1973, TO 2.8 PERCENT FROM 1973 TO 1979. THERE HAS BEEN VIRTUALLY ZERO GROWTH SINCE 1979. THIS HAS BEEN ACCOMPANIED BY A SHARP DECLINE IN NATIONAL PRODUCTIVITY, WHICH TRANSLATES DIRECTLY INTO LOWER STANDARDS OF LIVING. MY WRITTEN STATEMENT INCLUDES TABLES DOCUMENTING HOW POORLY THE U.S. HAS DONE IN COMPARISON TO OTHER INDUSTRIALIZED COUNTRIES AND HOW THE DECLINE IN PRODUCTIVITY AND GNP GROWTH HAS LOWERED LIVING STANDARDS. AS ONE CAN SEE, IN TERMS OF REAL GROSS WEEKLY EARNINGS, AND ESPECIALLY IN TERMS OF REAL SPENDABLE WEEKLY EARNINGS, AMERICAN WORKERS ARE MUCH WORSE OFF TODAY THAN THEY WERE TEN YEARS AGO.

THE PRESIDENT'S ECONOMIC PROGRAM WAS DESIGNED TO ALTER THESE TRENDS BY INCREASING THE REWARD FOR WORK, SAVING, AND INVESTMENT, BY REDUCING TAX AND REGULATORY BARRIERS TO PRODUCTION, BY REDUCING GOVERNMENT'S COMMAND OF PRIVATE SECTOR RESOURCES, AND BY STOPPING INFLATION -- IN EFFECT RETURNING THE ECONOMY BACK TO TO THE PEOPLE. INFLATION HAS ABATED, SHORT-TERM INTEREST RATES ARE

WELL BELOW THE LEVEL IN JANUARY 1981, THE GROWTH OF GOVERNMENT SPENDING HAS BEEN GREATLY REDUCED, AND GOVERNMENT SPENDING, TAXES AND THE DEFICIT ARE ALL DECLINING AS A SHARE OF GNP.

ALTHOUGH WE MUST SEE PROGRESS IN REDUCING THE SIZE OF THE FEDERAL DEFICIT, WE STRONGLY OPPOSE EFFORTS TO ACHIEVE THIS GOAL BY REDUCING THE SIZE OF THE SCHEDULED TAX CUT. IN THE FIRST PLACE, IT WOULD DO LITTLE TO ACCOMPLISH THIS GOAL, SINCE THE INCREASE IN BUDGET RECEIPTS FROM DELAY OF THE TAX CUT WOULD OFFSET ONLY A SMALL FRACTION OF THE ESTIMATED DEFICIT -- AND THIS ASSUMES CURRENT ECONOMIC GROWTH TRENDS, WHICH WOULD CERTAINLY BE LOWER IF THE TAX CUT WERE DELAYED. SECONDLY, THE PERSONAL TAX CUT BARELY OFFSETS THE TAX INCREASES TAKING PLACE SIMULTANEOUSLY, AS THE RESULT OF BRACKET-CREEP AND SOCIAL SECURITY. THUS ANY REDUCTION IN THE SIZE OF THE PERSONAL TAX CUT CONSTITUTES A SIGNIFICANT TAX INCREASE AND A SERIOUS HARDSHIP FOR ALL TAXPAYERS. IT MUST BE POINTED OUT THAT THE ADMINISTRATION'S PERSONAL TAX REDUCTION PLAN WAS SIGNIFICANTLY SCALED BACK AND DELAYED FROM WHAT WAS ORIGINALLY PRESENTED TO THE CONGRESS. INSTEAD OF THE 20 PERCENT TAX REDUCTION INTENDED BY JANUARY 1982, THERE WAS A 5 PERCENT PERSONAL TAX REDUCTION. AS A RESULT, THIS SCALE BACK HAS EFFECTIVELY POSTPONED THE FULLY INTENDED POSITIVE EFFECTS OF THE TAX REDUCTION ON OUR ECONOMY.

IN FACT, I ADVOCATE A MOVING UP OF THE JULY 1982 10 PERCENT PERSONAL TAX REDUCTION TO JANUARY OF THIS YEAR, OR AT LEAST APRIL. THIS WOULD PROVIDE A NEEDED STIMULUS FOR OUR PRESENT ECONOMIC DOWNTURN.

WE KNOW OF NO SCHOOL OF ECONOMIC THOUGHT WHICH ARGUES THAT TAXES OUGHT TO BE INCREASED DURING A RECESSION OR AS A MEANS OF INCREASING ECONOMIC GROWTH. WE BELIEVE THAT THE BEST WAY TO REDUCE THE DEFICIT IS TO ENCOURAGE ECONOMIC GROWTH OVER THE LONG TERM, AND THE RECENTLY ENACTED TAX CUT IS THE BEST MEANS WE HAVE FOR ACCOMPLISHING THAT GOAL.

THOSE WHO PROPOSE THAT SIGNIFICANT TAX CUTS BE TAKEN AWAY IN THE HOPE OF USING THESE TAX INCREASES TO BALANCE THE BUDGET HAVE FORGOTTEN RECENT EXPERIENCES. FROM FISCAL YEAR 1976 TO FISCAL YEAR 1981, THE TAX BURDEN ON THE PEOPLE OF THIS COUNTRY INCREASED BY $300 BILLION, REPRESENTING AN INCREASE OF ONE-THIRD OF OUR NATIONAL DEBT SINCE OUR COUNTRY WAS ESTABLISHED IN 1789. WHAT WAS THE EFFECT ON THE DEFICIT OF THIS DOUBLING OF THE TAX BURDEN DURING THESE YEARS? DEFICITS TOTALLED OVER $300 BILLION DURING THIS FIVE-YEAR TIME PERIOD, AND THE FISCAL YEAR 1981 DEFICIT OF $57.9 BILLION WAS ONLY $8.5 BILLION LESS THAN THE FISCAL YEAR 1976 DEFICIT. WHAT WAS THE EFFECT OF THIS $300 BILLION TAX INCREASE ON ECONOMIC GROWTH? ECONOMIC GROWTH DECLINED EVERY YEAR FROM FISCAL YEAR 1977 TO FISCAL YEAR 1980, AND IN 1981 WE HAD A MEAGER 1.9 PERCENT INCREASE IN REAL GNP.

THE MESSAGE IS CLEAR. IF THE LARGE PORTION OF THE STIMULATIVE TAX CUTS -- SUCH AS REMOVAL OF THE THIRD YEAR OF THE TAX CUT -- ARE RESCINDED, WE CAN LOOK FOR SLOWER ECONOMIC RECOVERY AND LARGER DEFICITS.

THE CONGRESS MUST REALIZE THAT EVEN WITH THE PRESIDENT'S SPENDING AND TAX REDUCTIONS ENACTED LAST YEAR, THE U.S. GOVERNMENT WILL STILL SPEND AND TAX MORE THAN IN ANY OTHER YEAR. THE REAGAN PROGRAM FOR ECONOMIC RECOVERY MADE SIGNIFICANT PROGRESS LAST YEAR. WE MUST NOT NOW RETREAT FROM THE COURSE ON WHICH WE HAVE EMBARKED.

IN 1963, PRESIDENT KENNEDY RECOGNIZED THE ESSENTIAL ELEMENTS FOR A STRONG ECONOMY, WHICH ARE INCLUDED IN THE PROGRAM FOR ECONOMIC RECOVERY, WHEN HE WROTE IN HIS ECONOMIC REPORT:

"ONLY WHEN WE HAVE REMOVED THE HEAVY DRAG ON OUR FISCAL SYSTEM NOW EXERTS ON PERSONAL AND BUSINESS PURCHASING POWER AND ON THE FINANCIAL INCENTIVES FOR GREATER RISK-TAKING AND PERSONAL EFFORT CAN WE EXPECT TO RESTORE THE HIGH LEVELS OF EMPLOYMENT AND HIGH RATE OF GROWTH THAT WE TOOK FOR GRANTED IN THE FIRST DECADE AFTER THE WAR."

WE DO NOT DEFEND DEFICITS. WE WANT A BALANCED BUDGET. THE REPUBLICANS ON THE JOINT ECONOMIC COMMITTEE HAVE FOR MANY YEARS BEEN CONCERNED WITH THE GROWING CONTROL OVER THE ECONOMY BY THE FEDERAL GOVERNMENT, THROUGH HIGHER AND HIGHER SPENDING. BUT WE STRONGLY BELIEVE THAT CALLS TO BALANCE THE BUDGET ON THE BACKS OF THE TAXPAYERS ARE MISDIRECTED AND ECONOMICALLY UNSOUND.

TABLE I.1

REAL GNP, TOTAL FACTOR PRODUCTIVITY, AND FACTOR INPUTS (Average Annual Growth Rates, 1959-79)

Period	Real GNP	Total Factor Productivity	Capital	Labor
			Total GNP	
1959 to 1965	4.3	2.5	3.8	0.9
1965 to 1969	4.0	1.9	4.1	1.2
1969 to 1973	3.6	2.3	3.5	0.4
1973 to 1979	2.8	1.2	2.5	1.6
		Private Nonfarm Nonhousing GNP		
1959 to 1965	4.4	2.5	4.1	1.0
1965 to 1969	4.0	1.3	5.8	1.3
1969 to 1973	4.1	2.4	4.2	0.7
1973 to 1979	2.8	0.6	3.2	1.8

SOURCES: Department of Commerce (Bureau of Economic Analysis), Gollop, Frank and Jorgenson, Dale, "U.S. Productivity Growth By Industry 1947-1973"; and Council of Economic Advisers

TABLE I.2

GNP PER EMPLOYED WORKER IN MAJOR INDUSTRIAL COUNTRIES (Percent Change, Per Year, 1963 to 1979)

Country	1963 to 1973	1973 to 1979*
United States	1.9	0.1
Japan	8.7	3.4
Germany	4.6	3.2
France	4.6	2.7
United Kingdom	3.0	0.3
Italy	5.4	1.6
Canada	2.4	0.4

*Estimate

SOURCE: Organization for Economic Cooperation and Development

TABLE I.3

GROSS SPENDABLE WEEKLY EARNINGS IN CURRENT AND 1977 DOLLARS

Year and Month	Gross Average Weekly Earnings		Spendable Average Weekly Earnings			
			Worker With No Dependents		Married Worker w. 3 Dependents	
	Current Dollars	1977 Dollars	Current Dollars	1977 Dollars	Current Dollars	1977 Dollars
1971	127.31	190.58	103.80	155.39	112.43	168.31
1972	136.90	198.41	112.19	162.59	121.68	167.35
1973	145.39	198.35	117.51	160.31	127.38	173.78
1974	154.76	190.12	124.37	152.79	134.61	165.37
1975	163.53	184.16	132.49	149.20	145.65	164.02
1976	175.45	186.85	143.30	152.61	155.87	166.00
1977	189.00	189.00	155.19	155.19	169.93	169.93
1978	203.70	189.31	165.39	153.71	180.71	167.95
1979	219.91	183.41	178.00	148.46	194.82	162.49
1980	235.10	172.74	188.82	138.74	206.06	151.65

SOURCE: Department of Labor, Bureau of Labor Statistics

TABLE I.4

INFLATION AND INTEREST RATES (Percents)

Year	Change In CPI	Average Treasury Bill Rate
1977	6.8	5.3
1978	9.0	7.2
1979	13.3	10.0
1980	12.4	11.5
1981	8.9	14.1
1981:		
Jan.	0.7	14.7
Feb.	1.0	14.9
Mar.	0.6	13.5
April	0.4	13.6
May	0.7	16.3
June	0.7	14.6
July	1.2	14.7
Aug.	0.8	15.6
Sept.	1.2	15.0
Oct.	0.4	13.9
Nov.	0.5	11.3
Dec.	0.4	10.9

SOURCE: Bureau of Labor Statistics and Department of Treasury.

TABLE I.5

FEDERAL BUDGET TRENDS
(Percents)

Fiscal Year	Growth In Outlays	Share of GNP		
		Outlays*	Receipts	Deficit*
1980	17.4	23.0	20.1	2.9
1981	14.0	23.7	21.0	2.8
1982	10.4	24.2	20.3	3.8
1983	4.5	22.5	19.4	3.1

*Including off-budget entities

SOURCE: Office of Management and Budget

TABLE I.6

GROWTH IN FEDERAL BUDGET RECEIPTS
(Billions of Dollars)

	1982	1983	1984	1985
Under existing law, administrative actions & proposed legislation	27.5	39.4	56.9	73.6
Under tax rates and structure in effect 1/1/80	56.5	75.1	90.4	91.7
Difference	29.0	35.7	33.5	18.1

SOURCE: Office of Management and Budget

TABLE I.7

FACTORS AFFECTING PAYMENT OF PERSONAL INCOME TAXES
(In Billions of Dollars)

Calendar Year	Increase			Tax Cuts**	Personal Net Change
	Social Security*	Bracket Creep	Total		
1981	6	13	19	-4	15
1982	13	28	41	-41	0
1983	19	53	72	-84	-12
1984	26	77	103	-116	-13

*Increase in tax rates plus increase in base above that consistent with growth of incomes.

**Rate reductions and reduction of marriage penalty.

SOURCE: Department of Treasury, Office of Tax Analysis

Senator **Kasten**. Mr. Chairman, I think that your testimony here today will be part of an emerging bipartisan consensus that the Reagan projected budget deficits are not acceptable. You seem to also agree that the same kind of crowding out theories that former Secretary of the Treasury Simon was talking about are as real today, maybe more real than ever before, and that we in the Congress have an opportunity to drive these deficits down. I am encouraged with some of the statements that both of you gentlemen are making

FOUR-POINT PROGRAM

Last year both the administration and Congress began with the idea of a four-point program which included tax cuts to restore the reward for work, savings, risk taking, entrepreneurship, and investment.

The second point of the plan was to restrain the growth in spending. I want to get back to your point that 60 percent of the budget, which is composed of entitlements, is uncontrollable. If we can have a bipartisan effort to bring entitlements under some control, we would be making a real step to control deficits.

Our plan for economic recovery also included regulatory reform and reasonable monetary policy. A year ago, interest rates were 20 percent; now they are about 16 percent. That is a significant difference, but 16 percent is not acceptable. We will not get the kind of business recovery we want without interest rates that are way below that 16 percent.

You and I both know the tremendous problems that interest rates are creating in Wisconsin right this moment. I share your concern with the high interest rates. I think that if we have any responsibility as politicians, as members of economic committees, it is to reduce those interest rates.

You recommend that the Federal Reserve Act to reduce interest rates, but you are not specific. You said that the Federal Reserve should return to the original targets for monetary policy established by the administration.

First of all, do you recommend simply that we produce more money? I agree with your statement that the Federal Reserve was too tight last year. You say that last year's target range of 2.5 to 5.5 percent was not met. You and I are both aware that they came in lower than 2.5 percent. It was 2.2 percent, and too restrictive. Mr. Volcker would argue, however, that the deficits were looking as if they were going to continue.

Do you consider the targets in the neighborhood of what would be reasonable? In your testimony you refer to "moderate activity," "restrained monetary policy" and "restrictive policy" without any numbers. Within the target range, what kind of direction should we be giving the Fed?

KEEP NONDEFENSE SPENDING AT REAL 1982 LEVELS

Mr. **Reuss**. Precisely. Before answering, could I, with the Chair's permission, give a quick answer to the question raised by Chairman Domenici before he left? The chairman said he thought our Democratic Joint Economic Committee point that nondefense spending should be kept at real 1982 levels, that is at 1982 levels plus an approximately 6 percent inflation deflator, or whatever the deflator is—Chairman Domenici said he thought we were being more restrictive than President Reagan's nonmilitary budget.

Let me set that straight. No, we are not. President Reagan's nonmilitary spending budget would cut total 1982 expenditures in real terms by 6 percent. Ours would cut them in real terms by less than 1 percent. Specifically by 0.9 percent.

If one says, well, how can you do that, the answer is clear. We would provide material budgetary savings by cutting the rate of growth in the military budget, by cutting the revenue depreciation inherent in that July 1, 1983, 10-percent income tax cut, and by markedly reducing interest rates, by a combination of budget deficit control and a slightly less restrictive Federal Reserve monetary policy which then reduces the deficit by cutting down on your interest payments.

FEDERAL RESERVE SHOULD LOOSEN OVERTIGHT MONETARY TARGETS

Now to your question, what is our interest rate and our monetary aggregate assumption. All that we say, Mr. Chairman, is that the Federal Reserve is too tight. Its corset, self imposed, is too restrictive. Last year the rate of projected growth, the corset, was 3.5 to 6 percent for 1981. In fact, they did not even come close to the bottom of that range, as you pointed out. It was only a miserable 2.3 percent. Not content with the havoc that was reached last year, they now want to make things worse. From a depressed base, they want to reduce the target from 3.5 to 6 percent to 2.5 to 5.5 percent. All that I believe Congress needs to say is, "do not do that, gentlemen." We are not telling you at the Fed what rate you have to hit. But do not restrict yourselves to 2.5 to 5.5 percent, particularly when in the first quarter you have greatly exceeded it, by something like 10 percent. So to hit the targets now in effect, the Fed will even have to be more cruelly restrictive in the remaining 9 months.

That is all I think it is necessary to tell by congressional mandate our friends in the Federal Reserve.

Let me say that is precisely what we told the estimable Arthur Burns and colleagues in 1975 when they were being too restrictive then, Congress passed a concurrent resolution saying to the Fed, "loosen your overtight monetary targets so that long-term interest rates can and will come down." They did, and the Nation was better for it, though later on errors on the other side were committed.

So that is all we, the Congress need to tell the Fed, namely, "do not impose an impossibly tight corset on yourselves."

For the rest, it would be entirely satisfactory to us and to me personally to have the Fed get back on the slowly decelerating 1980 to 1986 money supply track which looks toward a level of 3.5 percent by 1986. If you did that, it would mean that for the 2-year period 1981 to 1982, you would be creating new money not at the 1980 rate of 7.3 percent but at a rate of about 6 percent. We would not mandate the Fed even to do that. We would simply say, look, do not throw the country, even if we get the budget under control, into a permanent recession and permanently brutally high interest rates by over-squeezing the money supply.

MONEY SUPPLY INCREASE OF 9 OR 10 PERCENT

Senator KASTEN. Assuming your rate of increase in GNP, which using rough estimates is about 15 percent, it looks as if you are calling for a money supply increase of 9 or 10 percent. This would put us back on the horrible pattern of the past in which we had double digit inflation. We are in a good target range if we stick to 3 to 6 percent. If we are substantially above that, say a 9- or 10-percent increase coming out of the Fed, we are going back into the havoc of higher inflation. It would lead to higher interest rates in the long term.

Mr. REUSS. Let me respond. I appreciate the opportunity you give me and I will be brief, although somewhat more arithmetical than I like to be.

All that we advocate is that the self-imposed corset of 2.5 to 5 percent, particularly in view of its horrendous fracturing during the first quarter of the year, be released. We do not say how much but, of course, we had to give Data Resources a figure to put into their computer. What we did was to say this: Look, under the February 18, 1981 Reagan economic recovery program, President Reagan, with the Fed and the Congress agreeing, postulated a lowering of M_1 growth from 7.3 percent in 1980 to 3.7 percent in 1986, which is just one-half of it. If you project that year after year, you get 1981, 6.7 percent; in 1982, 6.1 percent; 1983, 5.5 percent: 1984, 4.9 percent; 1985, 4.3 percent; and 1986, hallelujah, world without end from here, 3.7 percent which is a good rate from here to eternity.

Now, in 1981, instead of hitting the 6.7 percent which was indicated, they hit only a third of that: 2.3 percent. So we said, what is needed is a biennial policy, which would work for the 2 years 1981 and 1982. So we factored in the 2.3 percent and that which would be needed to get a biennial approach which was just on target. So the figure put in for 1982, this year, the figure put into the computer, was 9.8 percent for 1982. With that, you get a 2-year figure which is not up to what Mr. Reagan and the Fed and the Congress said it should be for the 2 years but somewhat lower.

If you, Chairman Kasten, are mildly spooked at a 9.8-percent figure for 1982, remember, one, that we are not advocating that. We are simply saying get off of the 2.5-percent dime that you are on, and furthermore, even if they should produce a 9.8-percent figure, that is a great deal better than the preposterous 15-percent figure on which they have been so far embarked in the first quarter of the year. We can envisage a considerable lowering of that.

Senator KASTEN. I think many economists would be fearful of a money supply growth M_{1B}, at 9 or 10 percent, unless we can clearly demonstrate a balanced budget by 1985 or maybe even 1984.

Mr. REUSS. Which we can and if this committee can make and Congress will buy further cuts, we could make that balanced budget in 1984 rather than 1985, because we get the budget deficit down, says Data Resources, to $38 billion in 1984 which is within striking ground.

Senator **Kasten**. Senator Gorton?

SPENDING RESTRAINTS

Senator **Gorton**. Mr. Reuss, you and I have not previously had an opportunity to meet, although I, of course, have known you by reputation for a long, long time, I must say I would like to commend you for a set of ideas which do take a long step toward the kind of proposal which is something which can cause the great bulk of the Members of both parties to agree on a proposal. I think we have worked remarkably well toward a consensus. However, we are still a long way away from it. For your part of it, I should like to thank you. I should also like to say, if the Members of the Congress could be convinced that the formula or the program you outline would actually have the impact on real growth which your DRI figures show, it would become exactly to that extent very, very attractive.

Of course, the bottom line is the real growth in the economy out of which we can provide money for the private sector and the public sector as well.

I would like to ask you, however, in connection with this rather strong set of spending restraints which your program includes, both in defense and in discretionary spending where you are relatively close to the chairman of this committee on addressing all spending programs?

Mr. **Reuss**. The answer was all nonmilitary spending programs were addressed.

Senator **Gorton**. In any event, is your program, from the point of view of these spending policies, 1 year only? Does it carry any implications into it as to what happens in fiscal year 1984 and/or fiscal year 1985?

Mr. **Reuss**. Just 1984, for the reasons, Senator Gorton, that Data Resources, computer gets off the radar screen, runs out, in 1984.

MILITARY SPENDING

Senator **Gorton**. Are the same policy judgments about military and nonmilitary spending as applicable to 1984 as they are applicable in 1983?

Mr. **Reuss**. No, slightly different. Did you say military or nonmilitary?

Senator **Gorton**. Both.

Mr. **Reuss**. They are slightly different, Let me give them for both fiscal year 1983 and fiscal year 1984.

Mr. Reagan's military budget postulates an increase of 10.3 percent for 1983. The Joint Economic Committee that I have advocated here postulates a 5-percent increase, about one-half.

For 1984, Mr. Reagan postulates a 7.9-percent military increase. Ours postulates a 5-percent military increase.

Senator **Gorton**. So yours is 5–5?

NONMILITARY SPENDING

Mr. **Reuss**. Yes. On the nonmilitary side, Mr. Reagan postulates a 1983 percentage cut of 6 percent——

Senator GORTON. That combines discretionary and entitlement?

Mr. REUSS. Yes, sir. Ours, combining them, discretionary and nondiscretionary, envisages a decline of 0.9 percent, not quite 1 percent.

Senator GORTON. For 1984?

Mr. REUSS. For 1984, Mr. Reagan postulates a decline in nondefense expenditures across the board of 1.7 percent. We, the Joint Economic Committee Democrats, postulate a cut of 1.3 percent, mildly less.

Senator GORTON. But again the policy judgments that you have outlined here that we are going to increase that spending simply at the rate of the deflator are the same for 1984 as they are for 1983?

Mr. REUSS. Yes, sir.

Senator GORTON. They cover those 2 years and those 2 years only?

Mr. REUSS. Yes.

Senator GORTON. DRI's projections are based on that set of assumptions?

Mr. REUSS. Yes, and the only reason we stop at 1984 is that DRI's computer does not go beyond it. The reason I make bold to say that we get that deficit down to a balance by 1985 is interest costs would look better, growth would look better and we also think that something ought to be done about indexing which takes effect in 1985 and thereafter.

Senator GORTON. But that does not show up in this formula, of course, because it does not come into effect. I want to ask you a question later but I do need to ask Mr. Rousselot a couple of questions.

Mr. ROUSSELOT. I would be delighted to answer them. I must inform the chairman of the committee and my distinguished chairman of the Joint Economic Committee, before I knew I was going to substitute for Senator Jepsen, I made a very firm appointment on the House side for 3 o'clock today and I must part as it is now 2:55. But I will be glad to try to answer your questions.

DEFENSE SPENDING

Senator GORTON. Do you, either individually or does the group that you represent, agree with the chairman's proposals as far as the defense budget is concerned?

Mr. ROUSSELOT. No, not entirely. I will tell you that we did not go into detail on our judgments on defense—you are talking about defense spending?

Senator GORTON. Yes, defense spending.

Mr. ROUSSELOT. For 1982, 1983?

Senator GORTON. Right.

Mr. ROUSSELOT. We do not agree with our Democratic colleagues. Many of us believe that there is room for restraining growth in defense spending a little more than the President recommended. No part of the budget should be sacrasanct from consideration by the Congress.

Senator GORTON. So at least at the beginning——

Mr. ROUSSELOT. That is the most cautious statement I could make.

Senator GORTON. You have so much greater spending than Chairman Reuss?

Mr. ROUSSELOT. I am glad to hear him join us that it is possible to get a balanced budget by 1984. He said possible.

DISCRETIONARY SPENDING

Senator GORTON. Let me go on. Are you then assuming that we are going to pass and do you think we should pass the President's budget essentially unchanged as far as discretionary spending is concerned?

Mr. ROUSSELOT. No.

Senator GORTON. Or do you feel that we can afford to raise that somewhat by applying perhaps the same set of rules to both discretionary and entitlement spending as the chairman has outlined?

Mr. ROUSSELOT. We all believe we definitely have to address entitlement spending, that we have to put more substantial controls on the increases in entitlements. On the general subject of discretionary spending, I think that we have indicated that we feel we need to reduce them further too.

Senator GORTON. But less than the administration's budget?

Mr. ROUSSELOT. Well, I must say that I did not compare those calculations specifically so I am not prepared to answer that.

We are clearly, I want to emphasize again—we do not agree with the necessity for an add-on deficit of $91 million in 1983.

TAX ENHANCEMENTS

Senator GORTON. Now the President, of course, for all of the rather general statements we have, does include in his budget a number of increases in taxes.

Mr. ROUSSELOT. Yes, he does.

Senator GORTON. In spite of what you say about holding onto all of the tax cuts, I assume that you agree that we should raise revenues in at least the amount of the number that the President has recommended to us.

Mr. ROUSSELOT. I am now not answering for the members of the Joint Economic Committee but I know I can answer for the Republican members of the Ways and Means Committee. We are now searching for and looking for recommendations of what have become known as tax enhancements for 1983. We are in the process of making suggestions to the President of where we think there can be tax enhancements. That means tax increases in given areas. One specific area, for instance, that we are looking at in the Ways and Means Committee, and again I am not speaking for all of the members of the Joint Economic Committee, Republican members—is a prohibition that would roll back the threshold levels in raising unemployment compensation. For example, there exists in present law an exception that has been put in place where a couple who is earning $25,000—this is a specific, are now allowed up to $25,000, and that includes unemployment compensation. In other words, this couple has a tax exemption up to $25,000. An individual has an exemption up to $20,000. We intend to roll that back from $25,000 to $15,000 for a couple and from $20,000 to $12,000 for an individual and that will produce new revenue of a few billion dollars. So we are looking at that and other proposals. We used to call them closing tax loopholes. But we are looking at those types of things.

FREEZE COLA'S

Senator **Gorton**. Assuming our ability to bring the growth of Federal spending under the kinds of controls Chairman Reuss has outlined, is it still your position that we should not create some kind of revenue line which would bring us to a balanced budget by 1985? When Senator Domenici and I and several others of this committee took action, not dissimilar to that of the chairman, and talked about freezing COLA's and taking discretionary spending at its present dollar which is a little bit beyond what Mr. Reuss proposes for the next 3 years, we still cannot get to a balanced budget by 1985. We need substantially more in the way of revenue than the President's proposal will bring in.

Given the fact that there are various impacts for various proposals, are you not willing to consider those which combine very substantial fiscal restraints with some significant increases in revenues?

Mr. **Rousselot**. We have been impressed by proposals coming from this body that talk about freezing various COLA's. We think that is very constructive to look at the COLA's. I am speaking now only for myself being on the Social Security Subcommittee of the Ways and Means Committee. I do not exclude from that a potential increase even for social security recipients, increases we are talking about, maybe delaying, as the Democrats in the House did in their reconciliation bill—and they never talk about it much now, delaying the social security increase from July to October to make it coincide with the fiscal year. I thought that was an excellent proposal in their reconciliation package and that has out-year impact also. That is a proposal they recommended that in the reconciliation package and that is a specific as it relates to social security.

Senator **Gorton**. So did we.

Mr. **Rousselot**. Yes, I know.

Senator **Gorton**. You really did not answer the balance of my question.

Mr. **Rousselot**. No, I did not.

Senator **Gorton**. Thank you, Mr. Chairman.

FREEZE VERSUS DELAY

Senator **Kasten**. I would just like to ask the chairman, one or two more questions. I want to expand a tiny bit on the discussion Mr. Rousselot and Mr. Gorton were just having.

We have agreed that we have to put a freeze on all domestic spending or at least work to restrain domestic spending, including entitlements. Specifically we have got three or four plans over here. Mr. Hollings has an overall freeze. I have a 3-month delay. We have combinations of freezes and delays. We have certain kinds of programs that exempt Federal cost-of-living increases for Federal employees, other programs that include freezes of various kinds on Federal employees.

Have you, in your deliberations, looked at the idea of a freeze versus a delay? Which of those two do you prefer?

Mr. REUSS. I really have not anything very useful to say about how to handle the entitlement problem. I did say before, and I reiterate it, that nothing should be immune or sacrosanct and specifically I felt that the method of calculating some of the cost-of-living indices in the cost-of-living programs are archaic, should be reviewed, would yield in the doing of that budgetary savings which in no real sense disadvantage needy people. But I cannot at this moment say that the way to go is to freeze them or delay them or whatever. I am impressed by the fact that we have got to act in a few weeks and I believe that it would be perfectly possible to fashion a budget resolution which says overall 1982 domestic spending levels plus the deflator, and then have the staff simply fill in the 14 sub categories doing whatever this committee and the House counterparts in their wisdom decide should be done about the COLA's.

ACCELERATE TAX CUT

Senator KASTEN. I think it is clear that for the last few years COLA increases have increased faster than wages. The solution may be, as you are suggesting, to alter the housing component of the CPI or to do a number of other things so that these program increases not exceed the average increase in wage rates. I guess that is one of the things all of us can agree on.

You have pointed out that you reject the idea that unemployment is necessary to fight inflation. I agree with you on this point. Clearly we need an early and immediate end to this recession but it has got to happen with increased economic growth, the kind of economic growth we are all talking about. It seems inconsistent to assume high levels of economic growth, and at the same time suggest that we could increase taxes or at least defer tax changes. Even Keynesian economists agree that you do not increase the tax burden on individuals at a time of recession.

A couple of months ago you and John Kenneth Galbraith wrote a piece in which you came out in favor of speeding up the 1982 tax cut and to eliminate the 1983 tax cut. Even if we could get it passed, June would be the earliest that we could do so. It is already going to take effect in July. So we might have a moot fact. I have been working to speed up the 1983 cut, which would have a major impact, since we will be lagging in the economic growth that we need. It would propel us out of the recession. What we want to do is increase private sector spending and private sector investment and we can best do that by giving the private sector that additional 10-percent tax cut.

So I would like for you to respond to the idea of accelerating the tax cut and the importance of that tax cut in general.

REMOVE 1983 TAX CUT TO HELP CONTROL DEFICIT

Mr. REUSS. Yes, Mr. Chairman. First of all, I did advocate 3 months ago what has been called the first lady forward-second lady back approach, an analogy from the square dance which the chairman is so familiar with. We said accelerate to January 1, 1982, when you need it the July 1982 tax cut but push it back, probably into limbo, the July 1, 1983 tax cut when you do not need it because you then would be in an inflationary situation. As you pointed out, the locus has eaten the last 3 months and we have not done it. So it is no longer a viable proposal.

As to your proposal that we now accelerate the July 1, 1983 tax cut to January 1, 1983, I have to say that I do not believe I agree with you for this reason: What the world needs now is, in the next 6 weeks, is a signal from Congress that however profligate the administration, however obstinate the Federal Reserve, Congress has retained its sense of balance and is willing to do meaningful things to get control over the future budget deficit. If you are going to keep that July 1, 1983—the last best hope of Earth is to remove it so that we can get the budget under control the tune of an extra $40 billion of revenues a year. If you simply accelerate, you do not do anything about getting the deficit under control. I leave you at that point, Mr. Chairman, with the thought that really we have to attack on all fronts. We have to see that the unlimited growth in nonmilitary expenditures of the old days is not returned to. We have to cut back on the over-exuberant increase in the military. We have got to find some more meaningful revenues and the best way to do that is to get rid of the rather badly skewed 10-percent across-the-board income tax cut, a disprortionate share of whose benefits go to the same people at the top of the scale who are raking it in now and who, instead of investing, are speculating.

Finally, we have to do something about money.

So it is because your proposal destroys the congruence of what we are trying to present, that I have to regretfully say I cannot agree on that one point, though I am very heartened by your overall agreement between you and Senator Gorton, on the one hand, both considered to be conservatives, and myself, considered to be a progressive.

INCREASING GNP AND DECREASING UNEMPLOYMENT WILL REDUCE DEFICITS

Senator **Kasten**. I think I would suggest in conclusion that we are really not that far apart. The way to reduce the out-year deficits is clearly through job creation and real economic growth. You and I are both aware of the fact that 1 percent of unemployment is worth $25 billion, that 1 percent in GNP is worth $60 billion. By increasing GNP and decreasing unemployment, we can narrow the deficit. I think these are words that are worth a good deal of attention and consideration.

On behalf of the committee, I would like to thank you for your testimony on behalf of the Joint Economic Committee and remind you that there might be additional questions from other members of the committee who are not able to be here or from our staff. We will get them to you and hopefully you can return them to us within a fairly short period of time. We are very encouraged by your testimony this afternoon and thank you.

Mr. **Reuss**. We do our best and I thank my friend and colleague from Wisconsin and you, Mr. Chairman, for your courtesy and attentiveness.

[Whereupon, at 3:10 p.m., the committee recessed to reconvene subject to the call of the Chair.]

WRITTEN COMMITTEE QUESTIONS TO MR. STOCKMAN AND RESPONSES

Contingency Plans

Questions:

Given that we have made mistakes in predicting the economy in the past, what are the Administration's plans with respect to spending, revenue and other policy measures if:

1. The economy remains weak and the unemployment rate rises above 9%?
2. Private savings do not respond sufficiently to the new tax incentives so that interest rates remain high or even rise?
3. A weak economy coupled with high interest rates results in a rash of business failures?

Answer:

The Administration believes that its basic policies of tax reduction, restrained growth in outlays, fewer regulations, and limited growth of the money supply will set the stage for steady economic growth.

Tax and spending reductions were enacted last year, and regulations have also been curtailed. Additional changes are proposed for 1983. These policies are expected to result in steady economic growth soon. In view of this, contingency plans for an alternative economic scenario such as that suggested above have not been developed.

Deficits and Interest Rates

Questions:

In recent testimony you have stated that the President's program will lower interest rates if the deficit is held within tolerable limits.

1. What do you consider tolerable limits?
2. Are the deficits proposed by the President at the midpoint of the range or do they represent a high end of the range?
3. Some analysts believe that interest rates will decline if the inflation rate is diminished regardless of what happens to the deficit. Do you agree?
4. What will happen to interest rates if the President's recommended deficits are not realized? What will happen if Congress fails to act?

Answer:

1,2,3) The higher than projected deficits included in the President's budget result from a number of factors including the current recession, failure to enact some outlay reduction proposals, higher than expected interest rates, and more success than expected in reducing inflation, resulting in lower tax receipts. All of these factors result in higher deficits than expected. It is imperative that deficits be kept within the limits proposed by the President. Higher deficits could increase both inflation and interest rates and hinder the projected economic recovery.

4) If Congress fails to act on the President's deficit reduction program, deficits for the 1983-1985 could be $239 billion higher than projected in the Administration's budget. These increases would undoubtedly have the effect of increasing inflation and interest rates and affecting the expected economic recovery.

Underpricing of the Budget Deficit

Questions:

In examining the Administration's budget estimates, many appear to be highly optimistic. These reestimates could raise the FY 1983 deficit between $10 and $15 billion.

1. For example, Mr. Stockman, how do you respond to the charge that interest rates are now about two full percentage points above our projections for all of 1982? Wouldn't interest rates at current levels add $6 to $8 billion to the FY 1983 budget deficit?

2. In addition, the Administration assumed almost a doubling in receipts from OCS leasing and other land sales, yet Secretary Watt's recent statements indicate that a major increase in government leases is highly unlikely. Wouldn't lower leasing activity and less property disposal raise the deficit by $4 to $6 billion in FY 1983.

3. And what about CCC outlays? The most recent estimate we have from CBO indicates that CCC outlays will be $5 billion higher than the Administration shows in its budget. Even the Department of Agriculture estimates CCC outlays to be $2.2 billion higher than the President's budget shows and the year is not yet half over. Why are your estimates so far off?

4. What policy actions will the Administration support in order to reduce spending enough to offset these misestimates?

Answer:

In compliance with the requirements of the Congressional Budget Act, the Administration is planning to release reestimates of the 1983 budget by April 10. The April budget update will include reestimates and the reasons for them. These reestimates will include a reassessment of CCC outlays, which now appear to have been significantly underestimated in the 1983 Budget. Interest rates have been somewhat higher than those projected by the Administration, but not by the magnitude suggested above. The 91-day bill rate for calendar year 1982 was projected to be 11.7%. Recent market rates for these securities have been in the 12 to 13 percent range. For OCS leasing, we do not now anticipate major reestimates to the February budget numbers.

To the extent that reestimates result in higher outlays the Administration will make every effort to pare back other spending, so that the original spending and deficit targets can be achieved.

Risks in the Forecast

Questions:

1. What do you consider the greatest risks in the economic assumptions that underlie the budget? In terms of real GNP growth, inflation, unemployment and interest rates?

2. Most forecasts show lower real economic growth than the Administration's forecast projects. To what do you attribute the differences?

3. Most forecasts also show somewhat higher inflation and higher interest rates. What do these differences exist?

Answers:

1. The economic projections underlying the Administration's budget are based on our expectations of the economy, assuming enactment of all of the President's proposals, and a restrained growth of the money supply. Perhaps the single greatest risk to the forecast is congressional inaction on the Administration's budget savings proposals. Such inaction would result in higher inflation and interest rates and a much weaker economy.

2,3. The Administration has not analyzed in detail the projections of other forecasters, some of whom have less optimistic forecasts than the Administration. As discussed in Part 2 of the 1983 Budget, however, the Administration's forecast is in line with previous historical experience.

HISTORICAL INFORMATION ON BUDGET AUTHORITY

Questions:

Neither the President's budget nor any of the OMB background materials contains historical data on budget authority -- in total or by function and major program -- that is comparable to the President's budget request. In response to a request by Senator Hollings in February 1979, OMB Director McIntyre indicated that OMB was developing a system to collect this information beginning with FY 1977.

1. Could you furnish the Committee historical data on budget authority by function and major program from FY 1977 through FY 1983 using the format of Table 19 in the President's FY 1983 budget (appearing on pages 9-50 through 9-58)?

Answer:

The OMB staff has been maintaining a historical data base on budget authority by function starting with the budget authority for fiscal year 1976. Because of the many changes involved, it was not practical to reconstruct budget authority totals for earlier years on a comparable basis. The OMB computer data base has been available to congressional staff from the start of this project, but because of the small number of years covered in the data base it has not been considered appropriate to include these data in the regular historical tables. However, OMB staff is preparing a table showing actual budget authority by function and subfunction for the years 1976 through 1981 and the estimates for 1982 through 1987 from the 1983 Budget materials. Copies of this table will be supplied to your committee staff when the table is completed.

2. Would you be willing to publish such a table in the FY 1984 Budget and in the backup materials known as "Federal Government Finances" next year?

Answer:

Because of its limited audience and the amount of space involved, we are hesitant to add these data to the published budget. However, we will include the data in the Federal Government Finances package starting next year.

Current Services Estimates for FY 1984-1987

Questions:

Neither the budget documents nor the background information furnished by OMB provide current services estimates in any detail beyond Fiscal Year 1983. This makes it difficult for us to assess your out-year savings proposals in the area of non-defense, discretionary appropriations.

1. Would you provide the Committee with detailed current services estimates, by account, for the fiscal years 1984-1987?

2. Would you provide the Committee with a listing of your proposed non-defense, discretionary budget reductions from the current services base, by account, for the fiscal years 1984-1987?

Answers:

1. We have current law projections at the account level for most entitlement programs. We would be glad to share these estimates with the Committee. If you would like this information, please have your staff contact us so that we can discuss the technical details.

2. For other purposes, current services estimates by account were not prepared for the years beyond fiscal year 1983. In a mechanical sense, computations were made at the account level in the process of deriving aggregate estimates. The information at the account level was not reviewed for programmatic content.

3. The non-defense, discretionary budget reductions were not related to a current services base, by account, for fiscal years 1984-87. As is noted in answer to question 2, there is no current services base by account for these years.

OMB will consider making longer-range current services estimates for the next budget.

Federal Credit Activity

Question:

There are two measures of Federal participation rates in U.S. credit markets--lending (funds advanced) and borrowing (funds raised). For FY 1981, the Federal participation rate for the total of all funds advanced in U.S. credit markets was 21.2%. For funds raised, the rate was 34.8%. Which of these measures is a more appropriate indication of the Federal impact on credit markets? What rate of Federal participation in these markets do you feel is appropriate? Private economists estimate that the Federal absorption rate could reach 50% in FY 1982. What impact would such intervention have under your current economic scenario?

Answer:

The Federal Government was responsible in some way for 34.8% of the borrowing in U.S. credit markets in 1980. This measure includes direct Treasury borrowing (to finance spending and direct lending), borrowing by private lenders for guaranteed loans and borrowing by the Government-sponsored enterprises such as Fannie Mae. The figure reveals the broad reach of Federal influence in credit markets; however, because it is made up of diverse elements, with differing market impacts, it does not have a well-understood macroeconomic interpretation. All of the activities included place upward pressure on interest rates and tend to cause crowding out, though to varying degrees.

On the lending side, the Federal participation rate of 21.2% in 1981 includes all Federal direct and guaranteed loans and Government-sponsored enterprise lending. The amount differs from the borrowing rate primarily in that the financing of deficit spending is not included. The lending rate is the most useful measure of the impact of Federal credit programs on credit markets. It is important to be able to distinguish between the market pressure caused by deficit spending and that caused by Federal lending activities not only because their market impacts may differ somewhat, but also because one is controlled through the conventional budget while the other is controlled through the credit budget.

We do not anticipate that the rate of Federal absorption of funds raised (borrowing) will reach 50% in 1982. We expect a level closer to or slightly above that of both 1981 and 1982. However, if the Federal Government were to absorb an increasing proportion of credit market resources, real interest rates would not decrease as currently expected, and many private borrowers, including productive businesses, would be unable to afford or obtain long-term credit.

Federal Credit Activity

Question:

In the Administration's budget proposal for FY 1983, what are your assumptions about the difference in the impacts of direct loans compared to loan guarantees on credit markets?

Answer:

The impact of a Federal credit program on credit markets depends on the extent to which the program adds to total demand for credit. It if does not add to demand, it merely substitutes Federal provision of financial services for private provision. In other words, the credit market impact is greater if loans are given to borrowers who could not otherwise have received credit. This credit demand effect is independent of the form of loan financing — direct or guaranteed, because it depends solely on the credit worthiness of the borrowers. In general, however, highly subsidized programs are likely to generate more new credit demand than are programs with interest rates close to market levels. Most of the highly subsidized programs, with the significant exception of the guaranteed student loan program, offer direct loans. The largest guaranteed loan programs — FHA and VA mortgage insurance — are not highly subsidized and provide guarantees to many borrowers who could otherwise have received private mortgage insurance. Therefore, the direct loan portion of the credit budget is likely to have a somewhat greater credit market impact than does the guaranteed loan portion.

Federal Credit Activity

Questions:

If we assume that "crowding-out" does not occur in a recession, what is the justification for cutbacks in Federal credit programs in FY 1982? Do Federal credit programs ever "price-out" other borrowers? How can Federal credit activity be used to lower interest rates?

Answer:

"Crowding out" in credit markets does not necessarily end during a recession. The crowding out effects of Federal credit are very much a part of the reasons for the Adminstration's reduction in Federal credit for 1982. The Administration believes strongly that the large and detrimental financial market affects of Federal credit programs go beyond the crowdng out and interest rate effects operating at any given moment. Federal credit programs tend to reduce the productivity of the capital stock, and compete with private sector financial institutions. The Administration has made a major commitment to the task of reversing the growth trends in Federal credit. This task requires consistent vigilence throughout a period longer than a single budget cycle. The 1982 credit budget reductions reflect this long-term commitment.

The phenomenon of "pricing out" occurs when a prospective borrower finds that credit is only offered to him at a price higher than he can afford to pay, and he therefore does not borrow. Federal credit programs, by providing assistance at more favorable than market terms to program recipients, move other potential borrowers further back in the credit market queue. These borrowers face higher interest costs than would exist in the absence of the Federal credit programs, and some of these potential borrowers are "missed out" of the market as a result. The Administration believes Federal credit programs do "price out" other borrowers, and for this reason has proposed significant reductions in the credit budget.

Federal credit activity will aid in the reduction of interest rates only as its volume is reduced.

ADMINISTRATION PROPOSALS FOR STUDENT FINANCIAL ASSISTANCE

Question:

The Administration has proposed sweeping changes for student financial assistance programs. The President's Budget recommends that graduate students no longer be allowed to borrow under the guaranteed student loan program but instead can be accomodated under alternative Federal loan programs--namely, the parent loan, and auxiliary loans to assist students loan programs, which lend at near market interest rates.

1. Since borrowing and lender participation under these alternative loan programs was severely limites in FY 1981--only 4% of the size of GSL--how can the Administration assume that these programs will accomodate 700,00 graduate and professional students who borrowed under GSL last year? How will these students finance their education? What are the implications for industry, our nation's productivity, and scientific research if they cannot complete their degrees.

Answer:

We do not believe that the switch of eligibility for graduate and professional students from student loans to auxiliary loans will create a major hardship. By the 1982-1983 school year, we expect most States to have established the necessary procedures to implement this program. Auxiliary loans will be made available even in those States without programs under a contingency plan now being negotiated between the Department of Education and three guarantor agencies.

The switch from the GSL to the Auxiliary Loan program does not necessarily increase a graduate student's financial burden while in school. The Auxiliary(formerly the PLUS) Loan program will allow the full-time graduate student to defer payment of principal while in school or in a deferment period and will permit the interest to be accrued and capitalized for payment after graduation, if borrower and lender agree. We are also proposing to increase the loan limits of the Auxiliary Loan program from $3,000 to $8,000 annually and increase the aggregate limit from $15,000 to $40,000. Therefore, we believe that graduate students will not lose the ability to finance their education. They will ultimately have to pay higher interest rates for loans and will likely choose to finance a larger part of their education from their own or their families' resources. These conditions should apply to all seeking federal aid as we restore the prime responsibility for financing higher education to the family and curtail spending levels the government can no longer afford.

ADMINISTRATION PROPOSALS FOR STUDENT FINANCIAL ASSISTANCE

Questions:

The Administration also proposes that appropriations for the Pell grant program be reduced by 40% and that three of the campus-based aid programs be eliminated.

2. The proposed reductions for Pell grants and the campus-based programs are deep--representing a total cut of 50% from the FY 1982 Continuing Resolution level. How many students will be denied aid? In the face of rising tuitions and high unemployment, how will they finance their educations?

Answer:

The Administration does not believe that its proposals will have a negative impact on higher education. We cannot accept as a "floor" the levels of expenditure reached during the very recent, major expansion of federal aid. There have been neither large increases in enrollment as a result of a national need or federal policy, nor has this funding improved the quality of education available. What has largely resulted, we believe, is the replacement of funds from parents, local, State and private sources with federal dollars. The President feels that it is time to move toward restoration of the proper balance among these sources of financing for higher education costs.

We believe that students will not lose the ability to finance their education. They will ultimately have to pay higher interest rates for loans and will likely choose to finance a larger part of their education from their own or their families' resources. These conditions should apply to all seeking federal aid as we restore the prime responsibility for financing higher education to the family and curtail spending levels the government can no longer afford.

Education--In General

Question:

The Administration is proposing to convert the Department of Education into a Foundation for Education Assistance, consolidating major education programs into block grants to States and transferring others to various Federal agencies. The proposal directs that all responsibility for education programs would eventually devolve to the States.

Answer:

The Administration will propose to abolish the Department of Education and create a Foundation for Education Assistance. That legislation does not propose to convert major education programs into block grants to States. The 1983 budget does reflect the Administration's intention to seek consolidation of existing programs in the areas of vocational and adult education, education for the handicapped and vocational rehabilitation. Specific legislative proposals in these three subject areas will be transmitted to the Congress shortly.

The Foundation proposal does include the transfer of some existing programs to other Federal agencies. The proposed transfers represent our best judgment of what is the most effective administrative alignment of programs now administered by the Department of Education.

The Foundation proposal does not direct that all responsibility for education programs be turned over to the States. The proposed Foundation would retain responsibility for programs for the disadvantaged and the handicapped, for bilingual education, for all student assistance, for research and data gathering.

Education--In General

Question:

The budget proposals for education are extremely short-sighted. They come at a time when states are cutting back support for education programs. The cuts will lower our country's capacity to compete in an increasingly competitive and technological world economy.

How can you justify the draconian reductions proposed for education and the lack of commitment to educational opportunities so clearly demonstrated by this administration?

Answer:

The education proposals submitted to you were arrived at after considerable thought and discussion. Decisions about how and where to cut a budget are never made lightly, but reductions, we believe, are absolutely essential in order to reduce the deficit and restrain the budget. The reductions do not signal a lack of commitment to educational opportunities, but do indicate our preferences for how best to allocate the resources available for education and to move toward restoration of the proper balance among Federal, State, local, and family expenditures on education.

Details of our position with regard to student loans, Pell Grants and elementary and secondary education are provided below.

(1) Graduate and professional student access to Guaranteed Student Loans (GSL). The GSL program cost has skyrocketed. Costs in 1977 were $357 million. In 1983, even with our proposals, GSL will cost $2.5 billion; without them, $3.4 billion. Our proposals would end access of graduate and professional students to the regular GSL program, but make such students eligible for less subsidized Auxiliary Loans to the same extent, in loan limit terms, that they were eligible under GSL. Recipients will pay higher interest rates and many will have to rely more heavily on their own or their family's resources. We believe this proposal is a better way to achieve essential reductions than to curtail further loans for undergraduates.

(2) Pell Grants. This program has grown from an expenditure of $1.4 billion in academic year 1977 to $2.5 billion in 1980, when it was extended to include middle-income students. Our proposal of $1.4 billion in 1983 would return the focus of this program to the low-income student. Those students with the greatest financial need would receive the largest share of the funds.

(3) Elementary and secondary and other education programs. These programs have significant proposed reductions. In most cases, the Administration does not challenge the worth of these activities. We do challenge the recent rate of growth in Federal spending on them and the implied Federal/State relationship which that growth and attendant Federal intervention has led to. We believe that in most cases our legislative and regulatory simplification strategies will permit States and localities to offset some of the dollar losses by discarding unneeded and costly administrative processes imposed by the Federal Government.

ADMINISTRATION PROPOSALS FOR STUDENT FINANCIAL ASSISTANCE

Question:

Mr. Stockman, in last year's budget, the Administration justified eliminating social security student benefits to hundreds of thousands of students by saying that other student aid programs would be increased. I quote from the FY 82 Budget Revisions -- Additional Details on Budget Savings published April 1981:

> "Financial aid for adult students from Federally insured student loans, National Defense Student Loans, and Basic Educational Opportunity Grants (Pell Grants) would be increased for those needing assistance to offset the elimination of social security payments."

In the FY 83 Budget proposals however, you propose to:

*Cut Pell Grants by 40%
*Eliminate National Defense (Direct) Student Loans, and
*Make changes which will eliminate more students from the Guaranteed Student Loan Program.

Doesn't your proposal for this year break that promise made to social security student beneficiaries?

Answer:

The intent of the statement in the "Additional Details" was to illustrate that Federal student financial aid currently takes into account funds received for adult students under social security benefits and the elimination of such benefits would automatically increase eligibility for aid under these programs.

Given the necessity of achieving far-reaching reductions in Federal spending without affecting the ability of the Federal Government to assist those most in need, the Administration does feel constrained to make expenditure reductions in a wide variety of programs. We share your concern about the student financial assistance programs but in the budget process, difficult decisions had to be made about the funding level for each program in the context of a critical need to reduce the rate of growth of the Federal budget. In 1982, Federal spending on higher education in one year will almost equal what the government spent in eleven years from 1960 to 1970.

We believe, however, that the President's budget proposals will allow the student financial assistance programs to continue to be instrumental in opening the doors of our colleges and universities. In 1982, we estimate funds will be available for 2.5 million Pell Grant awards. About $9.5 billion will be made available for about 3.8 million new Guaranteed Student Loans. Campus-based student aid will provide an additional 2.4 million awards. In 1982, a total of 8.7 million awards and loans will be made available for eligible students.

In 1983, we are proposing to make available 1.8 million Pell Grant awards and to aid 1.3 million students through campus-based student aid funds. In addition, $10.3 billion will be made available for about 3.8 million new Guaranteed Student Loans. In 1983, a total of 6.9 million awards and loans will be made available under the President's budget request. In 1977, for comparison, Pell Grants (then called Basic Educational Opportunity Grants) provided 1.8 million awards to eligible students, the campus-based student financial assistance programs provided another 2.1 million awards and $1.5 billion was made available for less than one million Guaranteed Student Loans. In total, only 4.8 million awards and loans were made available that year, 30% less than projected for 1983.

1982 and 1983 HUD Subsidized Housing Program Levels

Question:

Will there be a net reduction from FY 1981 levels in the number of units that HUD assists in 1982 and 1983? Provide the program level detail supporting your conclusion.

Answer:

No, although we intend to deobligate a number of high-cost housing projects currently under contract commitment but with construction unstarted, the number of HUD assisted households will continue to grow in 1982 and 1983, as shown in the following table.

HUD Assisted Housing Units Under Subsidy Payment

	1981 Actual	1982 est.	1983 est.
Public Housing	1,204,000	1,238,000	1,276,000
Section 8	1,318,927	1,577,700	1,750,480
Homeownership Assistance	240,539	258,000	230,000
Rental Housing Assistance	376,206	375,000	374,000
Rent Supplement	157,779	98,000	38,000
TOTALS	3,297,451	3,546,700	3,668,480

Indeed, we expect the numbers of assisted households to grow to 3.8 million by 1985.

Guarantees of Mortgage-Backed Securities

Question:

The FY 1983 Budget proposes termination of the Government National Mortgage Association (GNMA) Mortgage-Backed Securities program at the end of FY 1983. Presumably, the function performed by this program would be assumed by the government sponsored enterprises supporting housing or the private sector. Please provide estimates of the increase in activity that is expected in each of these sectors as a result of the termination of the GNMA program.

Answer:

The 1983 budget does not reflect any specific decision on the level of GMNA loan guarantee commitments for the 1984-1987 period. For projection purposes the budget simply assumes a continuation of the 1983 commitment limitation level of $38.4 billion. The President's Housing Commission and the Administration are still reviewing the need for a permanent Federal government presence (through GNMA securities) in secondary housing markets. The success of private market alternatives to GNMA over the next year or two will significantly influence future GNMA levels.

The Administration believes that the GNMA reductions will not have a major impact on the amount of financing available to consumers for housing. Instead, GNMA reductions are expected to induce an even faster expansion of private sector secondary market alternatives, most notably, the mortgage-backed securities programs of both the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation initiated last year.

The following table provides information on the level of activity for GNMA, FNMA, and FHLMC as estimated in the 1983 budget:

Secondary Mortgage Market Activity
1983 Budget Estimates
($ in millions)

	Commitments		Mortgage Loan Purchases/Guarantees	
	1982	1983	1982	1983
GNMA	$48,000	$38,400	$28,500	$32,000
FNMA	N/A	N/A	$16,025	$15,950
FHLMC	N/A	N/A	$23,740	$28,924

The 1982 and 1983 proposed reductions in the GNMA mortgage-backed securities program are also consistent with Administration support of FHA and VA mortgage insurance and guarantee program activity levels for these years. The GNMA program will continue to finance about 75% of single-family loans issued from these Federal sources. GNMA currently estimates that a volume of guarantees issued of $32 billion in 1983 is adequate to support FHA and VA activity during the year.

Impact of Rent Increase Proposals

Question:

The Administration proposes to count food stamps as income for subsidized housing recipients, as well as raise to 20% the cap on annual rent increase and institute minimum rents equal to the cost of utilities. How much will these proposals increase the average rent paid by subsidized housing tenants? Can you estimate what the maximum and minimum rents are likely to be?

Answer:

As indicated in an answer to a question elsewhere, we expect to be providing assistance to 3.4 million low income households living in HUD subsidized rental housing in 1983. If the impact of the three separate proposals to increase rents is averaged over all of these 3.4 million households, it results in average monthly rent increase of $10 per household. However, it is not the case that all households will be affected by these proposals. We can isolate the effects of these proposals upon the households which will actually be affected. The results are as follows:

1) Count food stamps as income: $13 per household per month, on average, for households receiving food stamps.

2) Require minimum rent equal to cost of utilities: $36 per household per month, on average, for those households which currently receive a payment to help cover utility costs.

3) Raising the cap on the annual rate of rent increases: $3.40 per household per month, on average, for those tenants for whom the 10 percent ceiling would have an effect on rent levels.

We cannot predict what the range of minimum and maximum rents would be, except to say that with gross cash incomes including food stamps as low as $3,000 per year in some states with relatively low AFDC benefit levels, rents would still be expected to be as low as $25 per month despite the rent increase measures enacted in the 1981 Reconciliation Act and those now proposed.

LEGAL SERVICES CORPORATION

Questions:

1. The American Bar Association maintains that termination of the LSC will deny the poor equal access to the justice system. How do you respond to the ABA charge?

2. Last year, the Congress provided $241 million in funds for the Legal Services Corporation, rejecting the Administration's proposal to terminate the program. This year, the Administration renews its proposal based upon the same justifications. What further rationale can be provided to cause different action by Congress this year?

Answer:

We do not believe the poor will be denied access to justice as a result of terminating the Legal Services Corporation. The Constitutional right to counsel in criminal matters continues to be fully protected at the Federal, State, and local levels. The bulk of civil legal assistance for the poor, before creation of the Legal Services Corporation, had come from pro bono efforts of private attorneys. Under the Administration's 1983 Budget proposals, the $2.1 billion Social and Community Services block grants include adequate authority and resources for States to also directly fund added legal services activities which they believe are appropriate. With State and local governments, rather than a Washington-based corporation, making the decisions, legal services can become more responsive to the direct needs of their citizens.

We believe the private bar can also do more to support legal services for the poor. With over 500,000 attorneys nationwide, and an expressed professional ethic to provide free services for those unable to pay, the private bar is a large resource for civil legal assistance that can and should be utilized. A modest forty hours of donated time per attorney per year would generate more legal services for the poor than the Legal Services Corporation currently supports.

While the Congress has enacted interim 1982 funding for LSC under a continuing resolution, final action on authorizations and appropriations is not complete. Congress has been unable to agree on the proper role and structure for legal services since the LSC authorization expired in October 1980. We continue to believe that when Congress and the American public completes full consideration of the President's proposals, that they will be enacted.

Employment and Training

Q. What is the justification for terminating SCSEP (older Americans employment) and WIN (Work Incentive program) in a time of high unemployment?

A. Financing for SCSEP and WIN will not be terminated until October of this year. By that time we expect the economy to be recovering and unemployment to be dropping with increasing improvement expected throughout 1983 and beyond.

The fact that there will be no financing for these programs in 1983 does not mean that there necessarily will be an end to training or job opportunities for those eligible for these two programs. The Administration's 1983 program includes $200 million for job training, and job services for older Americans among others. A second part of our program is a $1.8 billion block grant to States for training. Our current thinking is that while the bulk of the block grant would be for services to those receiving AFDC and out-of-school youth, a portion could also be used for services to other groups including older workers. In addition, we would hope that those programs that believe their SCSEP employees are productive and provide valuable services (and we have received many letters pointing out that they are and do) will continue them as unsubsidized workers once the SCSEP financing disappears. One point should be stressed about SCSEP - while it does provide a part-time job it has failed its participants in the long run by not training them for a job or helping them to find unsubsidized employment. Transition to unsubsidized jobs in these programs is about 11 percent - far worse than the record of the larger CETA-financed PSE programs which we all agreed should be terminated as failures late last year.

While financing for WIN will be terminated, training services to AFDC recipients will not. As noted above, one of the two target groups in the State block grant for training is AFDC recipients. Even if only one-quarter of the participants served by the budget authority proposed for this grant were AFDC recipients, we would be training almost 275,000 each year for jobs in the private sector. In addition, States may continue the WIN program with their Social Service block grant resources if they desire.

Moreover, our program includes a mandatory Community Work Experience Program (CWEP) in 1983. This will require all States to establish a workfare program to assure that AFDC recipients are encouraged to find work in the private sector and perform useful public services when no private job is available. This proposal makes the WIN program superfluous.

Q. What are your estimates for increased federal costs in food stamps, AFDC, medicaid, medicare, and SSI as a result of these employment and training cuts?

A. We do not anticipate any increase in expenditures in these income support programs as a result of the proposals for the training and employment programs. AFDC recipients will be one of the two principal groups receiving training services under the Administration's proposed training block grant to States. To the degree that AFDC recipients find private sector jobs after training, AFDC and attendant income support costs would decline.

Q. Why are you eliminating funds for the new WIN demonstration program - a workfare program - before it even starts?

A. Congressional Action on the 1982 budget has already made it difficult to start the WIN demonstration program. The current Continuing Resolution provides less than what was available before enactment of the new program, $75 million less than requested by the Administration. States are dropping out of the demonstration program. 26 originally indicated they would participate, now only 20 are doing so.

In addition, the Administration's proposal to make AFDC recipients one of the two principal target groups of its block grant to States for training provides an alternative route to achieving the same end - jobs for welfare recipients. However, the proposal not to finance WIN in 1983 does not preclude a State that has already chosen the WIN demonstration option from conducting a WIN demonstration if it desires by using its social service block grant resources.

In addition, we are also proposing a mandatory Community Work Experience Program (CWEP) in 1983. This will require States to establish a workfare program to assure that AFDC recipeints are encouraged to find work in the private sector and perform useful public services when no private job is available. Under this proposal explicitly continuing the WIN demonstration would create a duplicative State and federal system.

Railroad Retirement

Question:

One of the proposals in the recently submitted budget calls for returning most of the railroad retirement program to the private sector.

1. What indications do you have that the private sector is prepared and willing to accept this responsibility?

2. How can this be achieved without disrupting benefit payments?

Answer:

Railroad labor and management collectively bargain the terms and conditions of the rail industry pension, with their negotiated agreements subsequently enacted as was done most recently last summer as part of the Omnibus Budget Reconciliation Act. Similarly, the massive restructuring of railroad retirement enacted in 1974 was based on the collectively bargained agreement of labor and management. The Administration proposal frees rail labor and management collective bargaining from the Federal involvement -- and potential interference -- associated with requiring legislation to conform the rail sector's industry pension to their negotiated agreement. The rail sector would continue unchanged its responsibility to finance their industry pension; social security would continue to finance the social security portion of benefits, except under the Administration proposal the Social Security Administration would directly administer social security benefits to rail retirees and their families. The Federal subsidy for windfall benefits would not be changed by this proposal.

Social Security

Question:

Your budget indicates that continuation of interfund borrowing and some medicare cuts will assure the solvency of social security for the next several years. Yet Social Security Commissioner Svahn has stated that the system has an $80 billion short-fall over the next five years.

1. Who's right?
2. Is the Administration too relaxed in its assumption that the Commission, the President, and the Congress will act in sufficient time to avert a genuine crisis in the fund?
3. What will you do if a depressed economy accelerates insolvency?

Answer:

The OASI trust fund is still estimated to have serious short-falls in the near term. Savings enacted during reconciliation last year plus a new set of economic assumptions reflecting a revised economic outlook have reduced the projected short-fall somewhat. Current estimates show that borrowing among all three social security trust funds could meet their combined benefit payments through FY87, although with very little to spare.

Medicare

Question:

The President is proposing substantial changes in Medicare involving provider reimbursement, inclusion of federal employees in the Medicare program, and requiring employer-based health insurance to continue primary coverage for workers when they reach 65. In addition, the Administration will soon send to Congress its proposal to increase competition in the health care sector.

1. With some $1.5 billion in savings assumed from changes in provider reimbursements and beneficiary copayments, do you believe that the additional savings attributed to the impact of your "competition" proposals of $1.9 billion in FY 1984 and $4.1 billion in FY 1985 are realistic?

Answer:

The assumed savings are a target to be achieved rather than a costing of a particular initiative, since our proposals in this area are sill under development. We believe the targets are ambitious, but not unrealistic. A reduction of about 2 percentage points per year in the rate of Medicare current services cost increases would meet the goals you mentioned. Given the tremendously excessive rate of health care cost increase we have experienced as a result of inflationary reimbursement systems and lack of any price discipline in the health care industry, we think reductions of this order of magnitude are reasonable goals for a well functioning market.

2. Will the requirement that employer/employee health insurance continue to cover the working elderly discourage the hiring and continued employment of older workers? Won't older workers be less attractive to employers and insurers?

Answer:

We don't think this proposal will have a significant impact on employers' disposition to hire or retain older workers. Unless an employer had a very high proportion of such workers, the impact on overall payroll costs of the somewhat higher health care costs of older workers would be negligeable. Moreover, since Medicare eligibles remaining in the labor force are presumably a fairly healthy group, it is unlikely that the health care costs an employer would experience from a sixty-seven year old employee who chooses to remain in the labor force would be much greater than, for example, a forty-five year old worker. Under Medicare, for example, 77% of enrollees average just $62 annually for medical care. Insurance companies should be indifferent to the change, since any increases in their costs would simply be reflected in group insurance premiums.

3. In proposing a 2% reduction in hospital reimbursement, are you not penalizing the efficient as well as inefficient hospitals?

Answer:

We designed the two percent reduction as an interim measure until market forces become effective. We think it is reasonable to ask the hospital industry as a whole--which has contributed so much to exessive cost inflation--to make some short-term sacrifices. Remember, even with the reductions we have proposed in this budget, payments to providers under Medicare will increase 12% in 1983. Virtually no other part of the domestic budget will do as well.

MEDICAID

Question:

The Administration is proposing a federal takeover of the Medicaid program in 1984 as part of its "Federalism" initiative. The OMB projects the States' share of expenditures at $19.1 billion in 1984.

1. Does the figure of $19.1 billion represent the maximum additional funding that will be proposed by the Administration to federalize Medicaid?

Answer:

The estimate of $19 billion of fiscal relief to the States is our best estimate of the State share of Medicaid costs for the current program. We recognize that costs for the health programs have generally been increasing at higher rates than for other programs in SWAP and the turnback proposals. From this viewpoint, the Federal Government is proposing to assume the higher risks of more rapidly increasing inflation under Medicaid. We hope, however, to achieve significant economies in the future through enhanced program efficiencies. On a long term basis, we hope to achieve savings through coordinating Medicaid program reforms with reforms of the overall health care financing system, in order to significantly reduce the overall rate of health care cost inflation.

Question:

2. Won't you have to equalize benefit levels to effect the takeover? How will you do this? Can equalization be achieved within the $19.1 billion total?

Answer:

We have not yet determined what level of benefits should be guaranteed under a federally financed Medicaid program, and in what time frame. We are currently studying the degree to which optional services and beneficiaries should be included in the program. In making decisions in this area, we must balance the importance of establishing uniform program criteria against the value of recognizing existing differences in States' programs and objectives. We are determined, however, that adequate coverage would be guaranteed for those most in need of health services financing.

Question:

3. Has any consideration been given to providing full federal funding only to portions of the existing Medicaid program such as the current mandatory services; or to specific groups such as the elderly or disabled? Would it make more sense for the Federal Government to pay for care of the elderly and disabled, leaving family medical services to the state and local level?

Answer:

We are still open to considering a full range of options. The one you mentioned is a particularly interesting approach. We welcome any suggestions you have, as we have welcomed and continue to welcome those suggestions offered by the States.

Question:

4. Will you integrate Medicaid with Medicare?

Answer:

Some portions of Medicaid may be well adapted to ultimate integration with Medicare, e.g., acute care services to the SSI population. Other portions, such as long-term care services to the retarded and mentally ill, may not be well adapted to an insurance model. We are looking at these issues closely, but no decision will be made until we finish our process of negotiation and consultation.

Question:

The states are having enough difficulty in adjusting to Medicaid program changes and reductions that were enacted in Reconciliation. The States will not want to attempt to implement the substantial new reductions you propose in the Budget.

5. Why not wait for Federal takeover before pursuing further reductions?

Answer:

Our takeover will not occur until 1984 and its scope and nature will not be determined until we finish our consultations and negotiations. Our budget situation, as I am sure you are aware, is such that we cannot afford to wait to take the actions necessary to bring this large, rapidly growing, and excessively costly program under control.

Health

1. On a number of occasions reference has been made to forthcoming administration proposals to improve market forces in health care. Would you please outline the proposals being considered which would increase incentives for the health care industry to cut costs?

Answer:

The Administration proposals are still under development. Options that are being looked at include ways to promote choice of health insurance plans and competition between insurers, ways to encourage people to select plans with higher co-insurance for non-catastrophic costs, ways to encourage growth of cost-effective systems of care, and ways to encourage conventional health providers to be more sensitive to market signals.

2. Currently, employees are given the incentive to sacrifice taxable wages for extensive and perhaps unnecessary health insurance coverage. As part of the competition strategy, is the administration considering changes to the internal revenue code which would provide an incentive for both employers and employees to hold down health care expenditure levels in the form of lower cost insurance options? Please explain these proposals.

Answer:

Changes in the tax treatment of health insurance benefits and health costs are among the options that have been considered. As you know, a variety of proposals in this area have been considered in the past by both the Senate Finance and House Ways and Means Committees. No decisions have been made in this area.

3. Changes in technology have helped to substantially increase the cost of medical care in this country. Are the proposed funding levels for Health Research going to foster a continued increase in our technological capability while imposing a decreasing ability to finance payment for that technology once marketed in the health care arena? Are we putting an equivalent level of resources into programs and services that will help maintain an adequate level of health for the population?

Answer:

I do not believe that improved technology is inherently inflationary. Research can help us cut costs as much or more than it produces cost increase. Compare, for example, the cost treating a polio victim over a lifetime of paralysis to the pennies we spend on a vaccination. The challenge confronting us is to create a health care market in which providers and consumers will be as interested in using cost-reducing technology as they will be in using cost-increasing technology. There could be nothing as conterproductive as government rationing of the products of medical science.

Commodity Credit Corporation Outlays

Question:

In response to questions during the recent consideration of the $5.0 billion supplemental appropriation for the Commodity Credit Corporation, the Department of Agriculture indicated that actual fiscal year 1982 outlays for the CCC programs were $8.5 billion through January of this year. This is $2.2 billion higher than the President's budget estimate and the fiscal year is not half over.

1. In light of the recent information on actual outlays in this fiscal year for the CCC programs, isn't it likely that the President's Budget estimate of CCC outlays for FY 1982 and FY 1983 are low?

Answer:

As noted in the President's Budget, the Commodity Credit Corporation estimates for FY 1982, FY 1983 and outyears were based on information used by the Congress last December during consideration of the Agriculture and Food Act of 1981.

Because these major amendments to the farm programs were not signed into law until December 22, 1981, the Department of Agriculture was not able to announce major discretionary program decisions until January 29, 1982. The uncertainty in the law governing the agricultural commodity programs, together with the lack of new world supply-demand data (published on February 11, 1982), precluded revision of the CCC estimates in time for publication of the budget on February 8.

In a March 5, 1982 letter to the House and Senate Appropriations and Budget committees, the Director of OMB provided preliminary outlay reestimates for FY 1982 and FY 1983 which were recently developed by the Department of Agriculture. These estimates will continue to be refined during the time remaining before submission of official reestimates in April. As weather, economic and commodity market conditions change, possible further adjustments may be necessary, though at this point it is impossible to predict whether outlays will be above or below the current estimates.

CCC Outlays
($ in millions)

	1982	1983
Budget	6,343	1,850
Current	10,460	6,736

Question:

The Administration's FY 1983 outlay level for the Commodity Credit Corporation does not seem to conform with traditional estimating techniques? Would you explain how the Administration's outlay level of $1.8 billion was developed and what farm policy assumptions are reflected in this number?

Answer:

The President's Budget estimates for FY 1983 Commodity Credit Corporation outlays were based on the supply/demand analyses and methodologies traditionally used by the Department of Agriculture. However, as stated previously, these estimates were those used by the Congress last December during consideration of the Agriculture and Food Act of 1981.

Because these major amendments to the farm programs were not signed into law until December 22, 1981, the Department was not able to announce major discretionary program decisions until January 29, 1982. The uncertainty in the law governing the agricultural commodity programs, together with the lack of new world supply-demand data (published on February 11, 1982), precluded revision of the CCC estimates in time for publication of the budget on February 8.

Since that time, the Department has revised its outlay estimates for CCC. The answer to the previous question provides the new outlay estimates. The following table provides the major crop prices assumed for the Budget (Farm Act) and current estimates.

Season Average Price Assumptions for Selected Commodities
($ per unit)

	1981 Crop		1982 Crop	
Commodity (unit)	Budget	Current	Budget	Current
Corn (bu.)	2.65	2.45	3.20	2.50
Wheat (bu.)	3.90	3.70	4.45	3.90
Rice (cwt.)	9.75	9.75	11.00	10.25
Upland cotton (lb.)	.60	.58	.85	.68

Rural Electrification Administration

Question:

Despite Congressional opposition in the FY 1982 budget debate, the Administration has proposed reductions in Rural Electric Administration (REA) loan activities in both FY 1982 and FY 1983. In light of the prevailing high interest rates and the limited access of rural electric utilities to the finance market, what would be the effect of the Administration's proposal on rural electric power rates and the cost of borrowing? What would be the savings associated with the restriction of rural electric utilities access to FFB borrowing? Couldn't the same arguments be made with regard to access to FFB financing by the TVA?

Answer:

1. Numerous sources are available to rural electric systems for credit and financing. Under the President's Budget, the Federal Government would provide at least $850 million in 1982 and $625 million in 1983 in subsidized insured (direct) loans and $4.245 billion in 1982 and $3.76 billion in 1983 in subsidized loan guarantees. In addition, rural electric systems would be able to obtain financing from the National Rural Utilities Cooperative Finance Corporation (CFC) and from many State and local public and private credit sources. Furthermore, many of the largest electric borrowers -- as well as most telephone borrowers -- are eligible for the tax benefits available to private companies provided in the Internal Revenue Code, including the latest amendments which permit sale and lease back of facilities. Finally, we understand that many generation and transmission cooperatives are resorting to the sale of tax exempt bonds to finance pollution abatement facilities at their power plants.

Since rural electric systems will continue to receive Federally-backed subsidized credit, as well as these other forms of Federal assistance, State and local financing should be easily accessible with reasonable, and in many cases below-market, interest terms. Therefore, the President's Budget for REA is expected to enhance the financial capacity of rural electric systems and not adversely affect rural electric power rates.

2. The President's Budget continues to allow rural electric systems unrestricted access to FFB financing within the total level of REA loan guarantees. Savings associated with the President's Budget for the electric loan portion of REA are: $225 million in direct loans in 1983; $900 million in loan guarantees in 1982; and $485 million in loan guarantees in 1983. These budget savings would not adversely affect rural electric systems, as noted above, especially considering that the 1983 loan levels would remain high: $625 for subsidized direct loans and $3.76 billion for subsidized loan guarantees.

3. The TVA has the same unrestricted access to the FFB as does REA.

HIGHWAY CONSTRUCTION PROGRAM

Question:

The Administration maintains that the Federal interest in highway programs is primarily supporting and providing for interstate commerce and the national defense.

1. To what extent might further reductions in Federal funding for highway programs be an impediment to interstate commerce or our national defense capabilities?

2. Further reductions in highway programs will most likely result in delays in some highway construction and maintenance projects. In light of the enormous escalation in highway construction and maintenance costs, to what extent will reductions in Federal funding for highway programs result in increased costs in the future?

3. Are there any safety implications associated with the reductions in the highway program that have occurred over the last three years?

Answer:

1. The Administration's 1983 budget continues a high level of funding for the highways primarily associated with interstate commerce and the national defense -- Interstate and primary.

2. Reductions in Federal highway funds do not necessarily result in increased costs in the future. The Administration proposes to make State and local governments responsible for determining the need for and priority of their highway projects. This action could, potentially, reduce the total cost of highway construction since it reduces Federal "red tape" and could eliminate marginal projects that increase the demand for scarce resources.

3. The Administration has and will continue to give safety a high priority. Safety implications are always considered in highway projects financed by Federal funds. We see no change in this emphasis with reduced funding.

AVIATION USER FEES

Question:

The Administration's budget states that if the proposed aviation user fee legislation is enacted, the Administration would support increased funding for airport facilities and equipment as the first stage of a 20 year, $10 billion plan to modernize the air traffic control system.

1. If the aviation user fee proposal is not enacted does the Administration plan to proceed with modernization of the air traffic control system; if the answer is yes, how would this plan be financed?
2. What problems will occur if we do not proceed with modernization of the air traffic control system?

Background:

The Administration is proposing legislation that would raise the aviation user charges that support the Airport and Airway Trust Fund. This proposal has been linked by the Administration with the need to modernize the air traffic control system over the next 20 years, costing approximately $10 billion.

Answer:

(1) The Administration believes that users should pay for the clearly allocable services they receive. Aviation is a case in point.

(2) Users' unwillingness to pay for capital improvements (and operating costs) calls into question whether the improvements are necessary.

(3) The budget does contain lower amounts for capital improvements ($535M vs. $859M for facilities and research) if our user fee proposal is not approved. (Funded from the Airport & Airway Trust Fund.)

(4) The lower levels would allow improvements to the FAA capital plant, but not at the rate possible if increased user fees are enacted.

(4) With these lower amounts, the system would continue to operate safely.

(5) However, it could not handle the traffic capacity or operate as efficiently as would be possible with more rapid capital improvements.

MASS TRANSIT

Question:

Reductions in mass transit funding most likely will result in state and local government assuming greater responsibility for financing public transit.

1. To what extent might additional reductions in Federal funding for mass transit result in deterioriation of transit services?

Answer:

a. Whether there is a deterioriation in service depends in large part on how transit operators and State and local governments adjust to reduced Federal transit subsidies:

-- Reduced Federal operating subsidy will increase the efficiency of existing systems by making possible local negotiation of improved work-rules.

-- Fares can increase. In real dollars, transit fares have declined since 1973, while the cost of the main alternative, the private automobile, has increased dramatically. Transit riders nationwide generally pay less than half of transit operating costs, and a much lower percent of combined operating and capital costs.

-- In addition, States and localities can increase tax revenues for transit.

b. The Administration proposes to direct UMTA assistance toward the large transit intensive cities. The proposed level of UMTA capital grants coupled with benefits from the leverage-leasing provision in the Tax Act will fund the capital rehabilitation needs of large transit intensive cities. They will not support development of new transit systems or expansion of existing systems.

As operating subsides are being phased out, remaining funds are being directed toward transit intensive cities.

Distribution of operating and capital funding demonstrates our priorities:

-- Tiers II and III of Section 5 operating assistance are cut about 20 percent. These tiers aid large urban areas most. Tier I which provides assistance to all urbanized areas is cut about 45%.

-- Of Section 3 capital grants, new starts and urban initiatives are cut most (33 percent and 100 percent, respectively) while bus and rail modernization grants fall about 2 percent. Bus and rail modernization funds can be directed towards our rail and bus transit intensive cities, unlike new start and urban inititive funds.

FEDERALISM - TRANSPORTATION

Questions:

The Administration's new Federalism proposal would return to the States approximately $6.4 billion in local transportation programs. Revenues from two cents of the Federal gasoline tax would be donated to the Federalism trust fund to help finance programs returned to the States.

1. If the Federal Government retains two cents of the gasoline tax and other highway user fees, is this sufficient to finance completion and preservation of our interstate highway program?

2. Does the Administration plan to require minimum standards for maintenance of our highway, mass transit and aviation systems that are returned to the States?

3. Both the highway and mass transit programs are scheduled for re-authorization this year. Traditionally, these programs are re-authorized for multi-year periods to allow for planning. In view of the Federalism initiative, will you submit a one-year authorization request?

Background:

The President's Federalism initiative envisions that two cents of the existing four cents per gallon motor fuel tax will be turned back to the States to fund non-interstate highway programs, including primary, rural and urban roads, bridge construction, and highway safety. According to the President's estimates, in FY 1983, two cents of the motor fuel tax would produce revenues of $2.2 billion. Non-interstate highway obligations are $3.8 billion in FY 1983. The Federalism proposal would also return airport grants-in-aid, Appalachian highways and urban mass transit programs to the States beginning in FY 1984.

Answer:

1. Funds retained by the Highway Trust Fund under the Federalism initiative are adequate to finance the Administration's program directed at: 1) completion of the Interstate system, as defined in current law, by the early to mid 1990's, and 2) increasing funds to assure preservation of the system.

2. Not all specific aspects of the Federalism initiative have been resolved, pending the outcome of the Administration's consultations with the Congress and the States. It is likely, however, that in the highway and transit areas when the programs are returned to the States there will be no minimum

maintenance standards. Inclusion of ADAP in Federalism would require re-examination of FAA regulatory requirements for airports. Undoubtedly, the FAA requirements would be reduced. However, no current requirements necessary to ensure aviation safety at airports would be abandoned.

3. The Administration's transit and highway legislation will include multi-year authorizations. The Federalism proposal would not require termination of these programs, at the Federal level, until 1988. Thus authorizations are necessary beyond 1983.

FEDERAL-AID HIGHWAY PROGRAMS

Question:

Mr. Stockman, the potential consequences of the Administration's short-sighted efforts to cut Federal spending across-the-board are very evident in the Federal-aid highway program. Our nation's highways and bridges are deteriorating at an alarming rate. Each year 2,000 miles of the interstate system will require major reconstruction and GAO estimates that $41.1 billion, in today's dollars, will be needed to repair or replace over 200,000 deficient bridges.

Last year, as the President was proclaiming the interstate highway system America's "paramount asset", he was proposing to reduce highway obligations to the unrealistically low level of $7.2 billion for FY 1982. We were told that it was an emergency, one-time budget cutting effort as part of the President's overall program. Fortunately, Congress did not approve such a drastic cut.

Yet this year, we are again confronted with an Administration proposal to disinvest in our nation's highways and bridges when the problems of maintenance and rehabilitation are increasing. The Administration's proposal to limit FY 1983 highway obligations to $7.7 billion is $0.3 billion below the current year and $1.1 billion or 13 percent below the FY 1983 limitation already established as a savings measure in the Omnibus Budget Reconciliation Act. If approved by Congress, this would be the lowest limitation on highway spending in five years.

1. What possible justification is there for continued cuts in highway spending, given the alarming increase in highway and bridge maintenance needs?

2. What do you see as the potential safety impact of these cuts in highway maintenance and rehabilitation activity?

Answer:

1. The Administration's 1983 budget continues a high level of funding for the highways primarily associated with interstate commerce and the national defense -- Interstate and primary. The bridge program also continues to receive significant funds.

   The Administration's budget reflects the annunciated position that there is a hierarchy of responsibility for addressing highway and bridge maintenance needs. The Federal Government has a responsibility to help address the needs associated with its role in supporting interstate commerce and providing for the national defense, while State and local governments should be responsible for those highway and bridge needs associated with roads basically serving intrastate and local travel. Given this policy, the Federal-aid highway budget represents a reasoned program to address highway needs.

2. The Administration has and will continue to give safety a high priority. Safety implications are always considered in highway projects financed by Federal funds. We see no change in this emphasis under the Administration's budget policy. Also, we are confident that safety concerns are a high priority of State and local governments and that they, like the Federal Government, will continue to emphasize highway safety.

Question:

Mr. Stockman, there is evidence to suggest that the proposed cuts in highway spending may actually cost more in long long run. Eventually, we will have to spend more money to make up for a period of neglect and deferred maintenance and the historical cost increases in highway construction have been significant. For example, highway construction and maintenance costs increased 145 percent and 105 percent respectively from 1970 to 1979, while the Consumer Price Index rose by only 87 percent.

3. How do you respond to this concern?

Answer:

3. We do not necessarily agree that there will be a "period of neglect and deferred maintenance." The Administration's budget maintains a high level of funding for highways of Federal interest. The States and localities likewise would be expected to address highway funding needs for highways of interest to them. In addition, the Administration's highway policy and its efforts to reduce "red tape" could, potentially, reduce the cost of highway construction, allowing funds to be used more effectively and efficiently. It should be noted also that in 1981 the bid price for highway construction dropped by about 4% from the 1980 level.

Question:

Mr. Stockman, there is some concern that the proposed highway spending reductions result from the President's reluctance to recommend an increase in gasoline taxes to adequately finance the Highway Trust Fund. Yet, the President has proposed increased user fees in other trust fund programs, particularly in aviation. Moreover, last year 22 States increased their gasoline taxes to meet growing highway needs.

4. Why is the Administration inconsistent on this important issue and will there be a proposal to increase Highway Trust fund taxes to support adequate highway spending?

Answer:

4. The Administration is not inconsistent in its approach to user charges. Highway users currently pay about 100% of the costs of the Federal highway program. The Administration's budget proposals continue this policy. Dedicated user charge revenue to the Highway Trust Fund will be sufficient to finance the Administration's proposed highway program. In contrast to the highway program, aviation users are not paying the full Federal costs for services provided for their benefit. The Administration's user fee proposal for aviation is designed to increase charges to recover 85% of the costs of federally provided aviation services (15% of the costs are associated with governmental use of the aviation system). Thus, the Administration's overall user charge policy is entirely consistent -- users should pay for the benefits received.

   The budget assumes that Highway Trust Fund taxes would remain basically at the current level. Some modification of the taxes could be possible as a result of the Highway Cost Allocation Study. Any proposal for an overall increase in taxes will be considered by the Administration.

Question:

With the economy in a recession, the proposed highway reduction is also ill-advised because of its effect on employment. Current estimates indicate that every $1.0 billion in Federal-aid highway grants creates 78,000 direct jobs in the construction industry and induces thousands more in related businesses. The proposed FY 1983 highway program of $7.7 billion would therefore eliminate well over 78,000 jobs which would otherwise be created under the $8.8 billion spending level already enacted in the Reconciliation Act.

5. In the face of mounting unemployment, why is the President recommending a further cut in one of the Federal programs most effective in creating private sector jobs?

Answer:

5. The Administration's program for economic recovery, affecting many programs in addition to highways, is designed to improve the overall condition of the economy and stimulate private sector growth to create jobs. Without the actions being taken by the Administration, the conditions of the economy would not provide the environment necessary for the long-term growth necessary to provide jobs, both in highway construction and elsewhere.

Coast Guard Capital Funding

Last year there was considerable discussion within Congress, including this Committee, about the need to provide the Coast Guard with additional funds to help it meet the many responsibilities given to it by the Congress and the Administration. For FY 1982, the Congress appropriated $684 million for the Coast Guard's capital program (Acquisition, Construction and Improvement), a level considerably above the Administration's request, to purchase additional vessels and equipment. The Administration intends to obligate this amount over two years (FY 1982-83) and has requested only $19.2 million in new capital funds for the Coast Guard in FY 1983.

QUESTION:

-- The Administration proposal to delay obligation of FY 1982 funds appears to contradict congressional intent to provide additional capital funds for increased Coast Guard responsibilities. Please respond to this concern.

-- The Administration has not yet requested a deferral of FY 1982 funds. Please address the budget impoundment and control implications of the Administration's proposal to delay obligation of FY 1982 capital funds.

ANSWER:

We do not believe the Coast Guard needs a major increase in capital funding. For the last several years over 80 percent of the Coast Guard's capital funding has been consumed by three procurement programs (270' cutters, HH-65A rescue helicopters and HU-25A search aircraft). The bulk of the funding for these programs will be behind us after 1983. Funding in the $300-$400 million range is quite adequate if the Coast Guard focusses on rehabilitation projects and the acquisition of more cost-effective vessels.

The $684 million appropriated by Congress was apportioned routinely by OMB and has been available to the Coast Guard for obligation. The sudden availability of the unrequested $300 million may present a practical problem for the Coast Guard contracting and engineering staff. The safeguards built into the design and procurement process may make it impossible for these additional funds to be obligated during fiscal 1982. The Coast Guard is reviewing its plans at this time.

A request for a deferral of funds that cannot be obligated would be transmitted once that determination is made by the Coast Guard. The Coast Guard budget for 1983 contains a schedule showing when and for what purposes these 1982 funds will be obligated. The Coast Guard usually carries some capital investment funds over to the following fiscal year because procurement actions cannot always be synchronized with fiscal year schedules.

Growth in Foreign Aid Commitments

Question:

Considering the economic difficulties we are now facing and the reductions in other non-Defense discretionary programs, how do you justify this large increase in foreign aid?

Answer:

o While total foreign aid commitments will grow by 36% between 1981 and 1983, most of this growth will be for security assistance programs.

o Programs in the international security assistance sub-function of the budget are aimed at the same national security objectives as the defense budget. As a result, they grow by 65% between 1981 and 1983, paralleling a rapid growth of the defense budget. Nearly one-third of the increase is for Egypt and Israel.

o Foreign economic and financial assistance programs, the other component of foreign aid, grow by 8% between 1981 and 1983. Most of this growth is for payments to multilateral development banks to meet commitments made by the United States during the Carter administration. All other foreign economic and financial assistance programs decrease by 3% between 1981 and 1983.

FOREIGN AID COMMITMENTS
($ in millions)

	FY 1981	FY 1982	FY 1983	% Growth FY 1981-83
International Security Assistance	5,320	6,764	8,763	65
Foreign Economic and Financial Assistance	5,277	5,397	5,685	8
of which:				
MDB's	1,004	1,262	1,537	53
All Other	4,273	4,135	4,148	-3
TOTAL	10,597	12,161	14,448	36

GROWTH IN FOREIGN AID COMMITMENTS

Question:

2. Most of our foreign aid now goes to countries with whom we share political or strategic concerns, and I support that type of allocation, but I am concerned that these friendly governments are becoming dependent on the billions of American dollars that we provide year after year. Are they using our aid to become more self-sufficent in food and energy? When can we expect some of these countries to graduate from the foreign aid program?

Answer:

A principal goal of the Administration's economic assistance is to reduce the need for concessional aid by recipients in the future. To that end, our aid programs are designed to develop self-sustaining productive capacities, particularly in food and energy. A major thrust of the Administration's economic assistance has been to increase the use of the U.S. private sector in development and to support the growth of private enterprise in developing countries. As countries are able to take on the financial burdens of development, they are "graduated" from U.S. concessional AID. In 1981, for example, Tunisia received its final commitment of AID development assistance.

National Forest Timber Receipts

Question:

The Administration's estimates for FY 1983 timber receipts represent more than a 30% increase over FY 1982 levels. This increase is based on a number of economic assumptions, particularly interest rates and new housing starts.

1. What are the Administration's specific assumptions regarding new housing starts in FY 1983?
2. What would be your estimate of timber receipts if the CBO estimate of new housing starts were used?

Response

Housing starts and general economic assumptions are only one of the factors utilized in projecting timber receipts. The housing industry is expected to begin a significant recovery in 1982 reaching 1.5M annual starts by the end of CY 1982. This recovery is expected to continue through the remainder of FY 1983.

CBO has apparently not made a specific estimate of housing starts but any decrease in starts from our estimates would tend to decrease receipts. We would expect the decrease to be modest unless starts were sharply lower or if there were major changes in provisions governing timber sales such as permitting contract termination at the purchasers option. Barring this sort of action, we believe our estimates are plausible. They are based on actual selling prices and the estimates of the volume to be harvested. The selling prices are lagged 4 years so those used for FY 1983 were actually bid for sales made in FY 1979. Volumes to be harvested are estimated based on the volume under contract (now over 33 BBF), the age of existing contracts, the anticipated level of sales for the future and anticipated economic conditions. The anticipated harvest volume is 10.6BBF for FY 1983. This is well under the level of sales for the past several years. While volumes to be harvested are impossible to foretell precisely, we believe our estimate to be reasonable and possibly conservative.

OCS Lease Sales

Question:

President Reagan proposes a significant increase of OCS receipts by offering larger areas for leasing and by streamlining leasing procedures. The FY 1983 budget estimates OCS receipts to rise from $7.9 billion in FY 1982 to $18.0 billion in FY 1983.

1. Given the recent oil glut and soft consumer demand, what evidence do you have that private industry will increase its bids to the levels estimated for FY 1983 and future years?

The Administration estimates are well above historical rates:

OCS RECEIPTS
(Fiscal Years; billions of dollars)

Actual				OMB Estimates	
1978	1979	1980	1981	1982	1983
2.3	3.3	4.1	10.1	7.9	18.0

Cash bonuses from sale of leases on OCS lands represent the largest component of OCS receipts. These bonuses are highly variable. They depend on such factors as: quantity and quality of acreage offered; subjective evaluations made by oil and gas exploration companies; available cash resources of the companies; world oil production and oil demand.

As a result of the current recession, conservation efforts, and high prices, consumer demand has slackened. Weak demand has reduced net oil industry profits and thus, available cash resources. High interest rates reduce the likelihood of companies borrowing large sums to bid on sales. All the acreage to be offered has not yet been specified (Secretary Watt intends to announce a final 5 year OCS plan by July).

Answer:

Because of technical budgetary presentation requirements, a comparison of 1982 and 1983 OCS budget receipts drastically exaggerates the increase in lease sale activity. Bonuses and rents in the budget are $4.5 billion in 1982 and $13.2 billion in 1983, an increase of 190%. Actual lease sale activity will not increase nearly as much. The attached table shows the adjustment of 1982 and 1983 budget receipts to reflect lease sale activity in those years. Industry payments resulting from sales in each year increase by 74% from $8.7 billion for 1982 sales to $15.2 billion for 1983 sales.

The industry has long sought increased leasing so that it can explore the continental shelf more rapidly. The proposed leasing program will increase acres offered for lease from 14 million in 1982 to 52 million in 1983. Reserves proposed to be offered increase from 4-6 billion barrels in 1982 to 28 billion in 1983. The average net value after costs of reserves proposed for offering increases from $2.95 per barrel in 1982 to $5.68 per barrel in 1983, due to greater emphasis in the latter year on the Gulf of Mexico. The budget does not assume that all of the offered reserves will necessarily be leased. On the contrary, it discounts its projections for 1983 to only 8% of the potential reserves value in order to take into account risk, uncertainty, possible delays, and other factors.

It is not possible to definitively determine in advance how the industry will respond to this opportunity for accelerating exploration. On the one hand, as your question has indicated, world oil prices have softened and may well reduce company cash flows available for capital investment.

On the other hand, the economic value of domestic reserves depends upon the prices likely to be in effect during the period of production. For OCS leases issued in 1983, most production is likely to occur in the time frame of about 1988 to 2007. Our analysis indicates that reasonable scenarios of future prices ensuing from the present price situation are likely to reduce the current economic value of 1983 lease offerings only moderately, if at all.

A much more difficult question is how the petroleum industry will modify its 1983 capital spending plans in response to the current economic and cash flow situation. Current trade press surveys of industry capital spending plans project a declining rate of increase. However, the rate of increase in spending is still well above the inflation rate. The industry's capital spending base is also sufficiently large--on the order of $100 billion--to provide significant flexibility in possible spending on lease acquisition.

In short, no one knows how aggressively the industry will respond to increased offerings of promising OCS lands. However, we think that the following points need to be strongly made:

- The offerings proposed have the economic values which the Government has placed on them.
- The budget has taken a highly conservative view of the monies which will be immediately realized from making such offerings.
- The industry has the capability to buy leases at the rates assumed in the budget.
- Owning reserves is highly important to each of the member firms of the industry. They have long sought more promising lands to explore and have every interest, even under current price conditions, in aggressively leasing what the Government offers.

Comparison of 1982 and 1983 OCS Sale Activity
($ millions)

	1982	1983
Budget receipts, bonuses and rents	4,521	13,207
Adjustment for 1982 sale receipts recorded in 1983 budget accounts	+1,718	-1,718
Adjustment for 1983 sale receipts recorded in 1984 budget accounts		+2,454
Adjustment for escrow amounts from 1982 sales	+2,486	
Adjustment for escrow amounts from 1983 sales		+1,277
Total sale activity in fiscal year	8,725	15,220

INLAND WATERWAY AND DEEPWATER PORT USER FEES

Questions:

The Administration's budget has reduced Corps of Engineers funding for maintenance of shallow draft harbors, waterways, and commercial ports based on the position that users should pay for these services rather than their being subsidized by the Federal Government.

1. In the event that the proposed user fee legislation is not enacted in time for FY 1983 collections, will the Administration raise its request for Corps of Engineers operation and maintenance activities?
2. What will be the Administration's position on alternative user fee proposals?

Answers:

1. If no user fees were enacted, then the Administration would not raise its request. The reductions we have proposed would affect only the least used and most costly ports and waterways. These reductions are defensible on programmatic grounds as well as grounds of equity to the taxpayer.

   If, however, user fees are enacted in the amounts the Administration has proposed, but the receipts would not cover the full $150 million reduction in 1983 due to timing, the Administration would restore the 1983 funds for navigation. We believe that in-place user fees would substitute a market test for lesser budget discipline on individual projects.

2. The Administration has repeatedly affirmed that it is receptive to alternative means of accomplishing the objective of recovering the allocable costs of Federal services from users.

   To be acceptable, however, user charges legislation must meet several tests. Acceptable legislation must provide for the recovery of the bulk of Federal expenditures, it must constitute a market test for Federal expenditures, and it must be equitable.

   One approach which would not be acceptable is to finance navigation projects from customs duties. Ports by themselves do not generate commerce (or the resulting customs receipts); ports are the gates through which the commerce flows, and are the convenient place administratively to assess the traffic. It is incorrect, therefore, to assume that ports are responsible for all customs duties, and on that basis reserve them to port dredging. Using customs duties (levied only on foreign commerce) to subsidize dredging services which also facilitate domestic trade would violate international trade agreements, which are a necessary condition for existing or increased levels of trade with other countries.

Dismantling the Department of Energy

Question:

The President has claimed that dismantling the Department of Energy will result in significant budget savings. Can you outline for us where you expect to achieve savings from dismantling the Department of Energy as opposed to savings from reductions in energy program activities?

Answer:

It is fairly simple to explain the savings resulting from both dismantling the Department and reducing or eliminating activities of the Department. The reduction in budget authority in 1983 from 1982 levels resulting from these proposed changes is estimated to be $1.3 billion. The reduction in outlays is estimated to be $1.1 billion.

The table below shows how these savings are derived based on the Department's three major areas of program activity:

	($ in millions)		
	1982	1983	Diff.
Budget Authority*	11,511	10,224	-1,287
Energy*	6,309	4,117	-2,192
General Science	529	601	72
Defense	4,673	5,506	833
Outlays*	11,668	10,572	-1,096

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* Includes off-budget funds for Strategic Petroleum Reserve purchases.

Providing a split of these budget savings into "those due to dismantlement" and "those due to programmatic reductions" can be done in only an arbitrary and theoretical way, as a moment's reflection indicates. Consider the Congressional Budget Office (CBO) analysis, which attempts to make this very distinction. It essentially concludes that the savings proposed in the President's budget are due to program reductions, not dismantling. According to the logic of the CBO study, the President might have proposed the same funding levels but continued the Department in existence. But that logic strikes us as theoretical and frankly misleading. Had the Administration proposed these funding levels but not proposed dismantlement of the Department, CBO or another watchdog group would have criticized us--and rightfully so--for disguising de facto dismantlement of the Department as mere program reductions. Savings from dismantlement and program reductions are clearly interrelated. Consequently, it seems to us arbitrary and misleading to assign savings to one category or the other.

Similarly, consider the savings proposed in the budget for Department of Energy overhead activities. CBO seems to imply that the reductions in overhead costs resulting from the President's proposals will be small to non-existent. But funds for overhead activities (Departmental Administration) are slated to decline from $286 million in 1981 to $229 million in 1982 and to $182 million in 1983--a total reduction of $104 million and 36 percent over a two-year period. These reductions are meaningful only in the context of substantially reduced level of Federal government energy activities--that is, the dismantlement of the Department of Energy.

Energy/Dismantling the Department of Energy

Question:

The FY 1983 Budget indicates that "dismantling the Department of Energy, together with other program reductions is expected to reduce 1983 outlays by approximately $1.0 billion below the 1982 levels." For the record, give a detailed breakdown of the $1.0 billion outlay savings. Be specific as to what savings are "programmatic" as compared to those savings resultant of the "dismantling of DOE."

Answer:

A summary of the budget request is presented in the table below. It shows the derivation of the $1.0 billion in outlay savings between 1982 and 1983, and a breakdown of the budget authority numbers for the three major areas of program activity in the Department of Energy.

($ in millions)

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Energy

Question:

The West German Bundestag recently agreed to continue support of their 300MW breeder reactor contingent upon the electric utilities agreeing to increase their share in the project cost from 8% to 28%. In light of this precedent, why does the Reagan Administration insist to bear the brunt of the cost of the Clinch River Breeder Reactor? Why hasn't the Federal government increased the utilities share in the project from the original 1973 level of $257 million since the total estimated cost of the project has increased from $422 million in 1973 to $3.2 billion in 1982?

Answer:

In 1973, the Clinch River Breeder Reactor project was estimated to cost $699 million. Of that amount, participating electric utilities pledged a total of $261 million. Counting the accrued interest, this figure will exceed $310 million. This agreement constitutes a contract where any increase in cost caused by delays, additional regulatory requirements, or increases in hardware costs would be the responsibility of the government.

The Utilities' contribution in 1973 amounted to over 30% of the original cost of the project. There is no consideration being given at present to request further funds from this group. In fact the cause of delay and the attendant cost increases were due entirely to the Federal government. The Utilities were not at fault. Because of the Federal government's failure to proceed with construction in previous years, these utilities even placed their initially committed funds into escrow in fear that their money would be expended and the project would never be finished. Thus, it is now hoped that the Federal government can restore credibility in it's commitment to this plant and therefore maintain the present contractual relations with the participating utilities.

With the strong administrative support for Clinch River in 1982, the current projected costs are at $3.2 billion. At this time the administration plans to fund the project adequately, get back on track, and proceed at a determined pace to construct the Clinch River Breeder Reactor in the shortest time and at the lowest cost.

Energy

Question:

Despite a surplus of oil on the world oil market, an enhanced rate of oil acquisition for the Strategic Petroleum Reserve (SPRO) is constrained by the amount of available storage capacity.

1. In light of the current world oil surplus, is the Administration considering alternative storage systems for SPRO such as conventional oil tanks or leasing oil tankers? What is the cost of alternative storage techniques as compared to the salt dome storage now being used at SPRO?

Answer:

The Reagan Administration recognizes that the Strategic Petroleum Reserve is an important element in lessening the Nation's vulnerability to severe disruptions in the supply of imported oil. In the first year the Administration took office, 122 million barrels (MB) of oil were added to the Reserve -- more than the total fill from all previous years combined. Development of near-term storage capacity has also been accelerated. It is now projected that an additional 47 MB of capacity will be available in FY 1985 than had been previously anticipated.

This Administration places a strong emphasis on ensuring that Federal programs are implemented in an efficient and cost effective manner. Therefore, alternatives to the current SPR facilities storage plan have been, and are being, evaluated to see if they will permit the program's objectives to be achieved more efficiently. For example, last year the Department of Energy (DOE) undertook a study of alternative storage options that would increase SPR's near term capacity. The study indicated that construction of steel tank storage would cost significantly more than underground salt dome storage and would provide only limited benefits in terms of storage acceleration.

DOE currently plans to conduct further inquiries into the advantages and disadvantages of leasing oil tankers and other forms of temporary storage. Leasing costs depend on several factors (e.g., timing, storage media) but are thought to be in the range of $1-4 per barrel per year.

The Administration will continue to periodically evaluate alternatives to the current facilities development plan and will incorporate into the plan any modifications found to be appropriate.

The Budget and the Poor

Question:

For business and middle class individuals you pursue tax cuts and various incentives to work and save. For low income persons, you remove work incentives for welfare mothers and cut benefits for working Food Stamp recipients.

1. Why does the Administration have a double standard for earnings incentives?

Answer:

There is no "double standard". The Administration's policy is to ensure that all Americans in the private work force have proper incentives to increase their income and keep more of their earnings. The President's Economic Recovery Program is designed to do this in several ways: (1) reductions in marginal tax rates for individuals, (2) increased availability of jobs through reforms of business tax provisions, and (3) Federal budget restraint which will help reduce deficits, Government borrowing, and inflation.

The Administration's proposals to reform welfare programs do not create significant work disincentives. Rather, by reestablishing the safety net character of public assistance programs, they focus benefits on those who are unable to support themselves. It would be inappropriate to compare public assistance benefits for those who are unable to work to the incomes of families who work in private sector jobs, as this suggests that families who can and should support themselves can choose whether to work or to rely on public assistance.

Historical experience has been that so-called "work incentives" such as the "$30 and a third" earnings disregard in AFDC have not been successful. The same share of AFDC recipients worked in 1967, before this disregard was put in place, as work today--14%. These provisions merely made higher income people eligible for public aid.

The Administration's proposals promote and expand work incentives. Tighter eligibility screens and absolute work requirements, notably "workfare" and job search, provide the needed work incentives for those who are capable of working and supporting themselves. The "$30 and a third" earnings disregard has been limited to the first four months of assistance to provide a transition into permanent work and self-sufficiency.

In addition, standardized work expenses and child care costs continue to be disregarded for AFDC purposes. A $1.8 billion Employment and Training block grant to States is proposed, with AFDC recipients as a key target group. The 1983 Budget requests a $2.0 billion social services block grant to States, including authority to fund child day care and education, training, and employment services. These will build on the work incentives to help people obtain and hold jobs and be independent.

The Budget and the Poor

Question:

1. Can tenants pay their rent with food stamps. Will the poor be forced to choose between heating and eating? Is the Administration attempting to defeat Congressional earmarking of aid for nutrition or energy needs?

Answer:

The inclusion of energy assistance in calculating income for AFDC and Food Stamps and counting Food Stamps in determining housing assistance is part of the Administration's effort to assure that all sources of income available to a family are counted when calculating benefits for a particular public assistance program. The exclusion of certain kinds of benefits as income has meant that a substantial amount of the resources available to households has gone uncounted, which distorts the picture of the household's need for assistance under these programs. This proposal would eliminate the inequity that has existed between households which have these outside resources and households that do not.

The poor will not be forced to "eat or heat" if energy assistance is included in determining income for AFDC and Food Stamps. For example, the average household's monthly food stamp allotment would decrease by only $8 during the winter if energy assistance payments are counted as income. If households have high energy expenses, they can deduct a portion of these costs under the excess shelter expenses deduction in the Food Stamp program. In calculating income for Food Stamps, households can deduct shelter costs in excess of 50 percent of net income, which helps protects their Food Stamp benefits.

The inclusion of Food Stamps in calculating income for housing assistance will also have a small impact on benefit levels. Counting Food Stamps as income will result in a rent increase in public housing of $13 per month. Even after including Food Stamps as income, the rent in subsidized housing is still substantially below average unsubsidized rent.

The Budget and the Poor

Question:

Why hasn't the Administration pursued your own ideas about expanding the Earned Income Tax Credit which decategorizes income assistance?

Answer:

The Administration's economic proposals are the most direct way to assist the working poor. Lower taxes will increase their real income, and reduced inflation will preserve the value of their income. A strengthened economy will also increase the goods and services available to all.

In addition, a major Administration initiative is being proposed that would sort out the responsibilities of the Federal, State, and local levels of government, particularly for programs serving the poor. This proposal would substantially modify the current systems of income maintenance and medical care assistance and is currently being negotiated with the Congress, States, localities, and other interested parties. It would be inappropriate, therefore, to consider expanding the Earned Income Tax Credit when these other major reforms are being worked out. The Earned Income Tax Credit should instead be reviewed in light of the resulting systems of support for low income people.

ELIMINATION OF VETERANS DEPENDENTS' ALLOWANCES UNDER VOCATIONAL TRAINING PROGRAMS

Questions:

The budget request proposes to eliminate the payment of certain dependents' allowances to veterans in vocational training programs when they also receive allowances under the compensation program. The Veterans Administration estimates FY 1983 savings of about $19.7 million under this proposal.

1. How many recipients would this proposal affect?
2. What would be the combined effect of this proposal be with that to limit compensation benefits to veterans with disability ratings of 50% or higher? How many individuals would experience benefit reductions?

Answers:

1. 22,400 Vocational Rehabilitation recipients, who are receiving duplicate subsistence allowances (for both education and compensation purposes), would be affected by the proposal to eliminate duplication.
2. 6,100 Vocational Rehabilitation recipients would be affected by the proposal to limit compensation benefits to veterans with disabilities of 50% or greater.

VETERANS CORRESPONDENCE TRAINING REIMBURSEMENTS

Question:

The Administration has again proposed the elimination of veterans correspondence training reimbursements. As you will recall, the Congress modified the correspondence matching rate from 70% to 55% in last year's Omnibus Reconciliation Act but refused to eliminate it.

1. Why is the Administration proposing this after the Congress has failed to act on this proposal?

Answer:

Legislation to eliminate correspondence training has been proposed on five previous occasions. The rationale for eliminating this benefit remains the same. The program has not met its objective of providing substantial employment for those trained. It is used primarily for recreational or avocational purposes. (Less than half of those completing correspondence training have full-time jobs related to their training.)

ELIMINATION OF VETERANS DEPENDENTS' DISABILITY COMPENSATION ALLOWANCES

Question:

The FY 1983 budget proposes several eligibility rating and payment changes in veterans compensation similar to those recently enacted for Social Security.

1. What is the Administration's rationale for targeting cuts in benefits to veterans with service-connected disabilities and their families during these difficult economic times?

Answer:

These proposals would:

-- eliminate the current provision of law which provides payment at the 100% rate to veterans who are rated between 60% and 90% disabled and who are judged to be "unemployable," even though they also receive Social Security, SSI, or Federal retirement benefits.

-- restrict dependents allowances to veterans rated 50% or more disabled. Prior to 1978 only veterans rated 50% or more disabled received allowances for their dependents. In 1978, legislation was enacted extending dependents allowances to veterans with 30% to 40% disabilities.

The rationales for the proposals are that:

-- receipt of other Federal disability or retirement benefits is evidence that these veterans receiving VA "unemployability" payments either do not have the intent or do not have the capability of re-entering the labor market.

-- restricting dependents allowances to veterans rated 50% or more disabled would reduce compensation benefits to a large number of veterans with relatively minor disabilities such as flat feet, severe chronic laryngitis, severe convulsive tic, or a moderate ulcer. This would restore the emphasis of this program to aiding those veterans most in need whose service-related disabilities clearly and substantially restrict their employment opportunities.

FEDERALISM INITIATIVE

Questions:

1. When do you expect to conclude the consultation process on the federalism initiative and submit a legislative proposal to the Congress?

2. Is the Administration flexible on all aspects of the federalism program? For example, would the Administration be open to a program swap other than the proposed Medicaid/AFDC-Food Stamp swap if that one proves unacceptable to Congress?

3. Given the extensive consultation to which you are committed before you submit draft legislation to Congress and the fact that the federalism initiative cross-cuts Congressional Committee jurisdictions, do you think the FY 1984 start-up date is realistic?

4. Reductions are proposed for a number of programs to be "swapped" or "turned" back to states in FY 1984 as part of the Administration's federalism initiative. I assume the $28 billion trust fund amount takes into account these reductions. Will the level of funding for the trust fund be adjusted to reflect any different spending decisions made by the Congress for FY 1983?

5. Some of the trust fund monies will be used to equalize winners and losers on the swap. This will leave winners with less money for "turned back" program responsibilities. As I understand it, the state "pass-through" requirements are intended to assure local governments of 100% continued funding if the state opts out of specific direct Federal-local programs and for a "super general revenue sharing" payment. Will that "pass-through" mandate be applied only to that reduced federal amount for turned back responsibilities or will it apply also to the state's entire trust fund allocation, including the state money freed up in the swap?

6. Is the present general revenue sharing program which now provides unrestricted federal fiscal aide to local governments one that local governments can be assured of 100% funding for if the state opts to go for a super revenue sharing payment?

7. What assurance will be provided to states that changing political tides will not alter this restructuring of responsibilities somewhere along the road? What assurance can be provided that the federal government will keep its hands off excise taxes after 1991 for example?

8. Will the plan seek to address differing fiscal capacities of states in its final version?

9. I note that the Urban Development Action Grant program is on the Administration's sample list of programs to be traded back to states. I think it is fair to say that the Administration believes that community revitalization should be the primary responsibility of the states. At the same time, the Administration is proposing the creation of urban enterprise zones; this would establish a new federal involvement in urban renewal. Don't you think there is a conflict in your policies?

10. Won't the proposal that AFDC and Food Stamps no longer be shared federal-state programs but rather be fully funded and controlled by the states be seen by many people as an attempt by the federal government to walk away from the nation's most serious poverty problem--the 11 million mothers and children on AFDC? Is it the Administration's position that income support for families with children is not a federal concern?

11. How do you justify making medicaid services for AFDC families a federal responsibility while practically all other benefits and services for this group is a state responsibility?

12. How will the state-to-state differences in the medicaid programs be reconciled when it is taken over by the federal government? Won't it be tremendously expensive to establish uniform national eligibility and services in the medicaid program?

Answers to Senate Budget Committee
Questions on
Federalism Initiative

1. As you know, we have held extensive consultations with state and local officials which are now coming to a close. We will be drafting legislation, which we hope to submit to Congress by mid-April.

2. While we have certainly been flexible on the details of the Initiative, we are still committed to its larger framework - a clear sorting out of federal and state roles in income maintenance and health services linked with a return of programs and tax sources.

3. Yes. FY 84 not only begins a 4 year phasing-in period, but it also comes two years after the states have had experience with planning for and administering block grants.

4. The trust fund total is set at the total funding for the turnback programs in 1984 carried forward from the 1983 budget, adjusted for the net effect of the SWAP. Should funding levels other than those proposed by the Administration for turnback programs be enacted, the trust fund would be adjusted accordingly.

5. We have not worked out the complete details on the dollar amounts that are to be subjected to the pass-through provisions. A number of options are available involving the trust fund allocations as adjusted or not by the effects of the SWAP. Our objective is to have an equitable pass-through of monies to local governments and we are working toward that end.

6. Yes. The 100 percent pass-through to local units of government applies to federal programs which presently provide direct federal to local government payments. The general revenue sharing program is in that category of programs.

7. Really no assurance can be given to the states that changing political tides will not alter the future assignment of federal/state responsibilities under the President's Initiative, nor that the federal government will not impose new excise taxes after 1991. The only assurance that can be given is that this Administration will propose strong, clear legislation. Further, the Administration will faithfully administer the Initiative within the intent of the statute.

8. The plan does not presently address the differing fiscal capacities of the states. This is an approach being advocated by others and one which we are reviewing during the consultation process.

9. No, there is not a conflict between our policies. The Administration believes that local community and eocnomic development should be a responsibility of the states, except where the federal government is the only level of government capable of implementing a specific policy. Clearly, grant programs, such as the Urban Development Action Grant (UDAG) program, can be undertaken by states; hence, the UDAG program is included among the Federalism turnback programs. By contrast, programs emphasizing federal tax and regulatory reductions require a federal role since only the federal government can reduce federal taxes and federal regulations; this is the rationale behind the federal role in the Administration's recently announced Enterprise Zone proposal. Two important aspects of the Enterprise Zone proposal should be noted: (1) The Enterprise Zone proposal does not call for increased federal action, but rather for reducing federal constraints on the free-market system; and (2) The Enterprise Zone proposal is not simply a federal government effort. To be successful, Enterprise zones must have substantial contributions from states and local governments (e.g., state and local tax relief, beneficial zoning decisions, and public services improvements). In fact, state and local contributions would probably make the critical difference in whether a zone succeeds or fails.

10. While there is to be a lessening of the federal role, the Administration believes there will be an improvement in the operation and services provided under these programs. The states are basically free to administer the AFDC/Food Stamps programs. We feel they can more effectively design, target and run the programs because of the experience they have had with the administration of these programs and their familiarity with local causes/sources of unemployment and poverty. In addition, when states are responsible for the programs, their incentive to manage programs effectively and reduce fraud and waste is enhanced. During the transition phase of the President's program, there will be a federally required flexible maintenance of benefits provision for the state-run public assistance programs. The objective, however, is to assure that states respond appropriately to the needs of the truly needy without burdening the states with a complex set of federal requirements that do not permit them to operate efficient programs well targeted on the needy.

11. There are several reasons for this approach. First, because of the size of the Medicare program, the federal government will continue to be the nation's largest single purchaser of health care services, regardless of the SWAP configuration. Hence, it may be appropriate to retain federal responsibility for both programs to encourage a unified approach to reform of the health care industry. As you know, one of the Administration's highest priorities is to improve market forces in this industry, which has been one of the most inflationary forces in the budget and the national economy. Second, Medicaid is the most rapidly growing public assistance program, and we believe increasing federal responsibility for it may be a fair trade for the increased responsibilities states will assume in other areas. However, we are open to consideration of different configurations for the SWAP, and negotiations are proceeding with the states.

12. This is a difficult problem. We are actively discussing it with the Governors and others, and we would welcome any suggestions you might have. However, it is unlikely that the federal government will assume all current state optional Medicaid components.

Question

The Administration is lavish in its praise of the responsiveness, flexibility and efficiency of the state and local governments. It says it wishes to capitalize on this by simplifying federal grant requirements and even by turning back functions to state and local governments.

But a look at the record of the last year, and proposals for the future, make it appear that the administration really wishes to saddle local governments with responsibility for what were heretofore federal programs, while refusing to give them the resources to carry out these new responsibilities.

For example.

The Administration brags that it established 9 new block grant programs last year. But at the same time it cut total funding to state and local governments by $3.6 billion in FY 1982 -- a real decrease of at least 10-12%.

For FY 1983 the Administration wants to "help" state and local government even more by setting up 7 new consolidated grants and adding to 3 existing block grants. But it also proposes to decrease aid to states and localities by $9.8 billion -- a real decrease of at least 15%.

So far we have handed increased responsibility to state and local government and cut their real funding by 25%!

Does the Administration seriously contend that this is a way to strengthen local government and to encourage it to assume greater responsibilities?

Answer:

The most important aid that the Federal Government can provide to States and localities is to promote and encourage steady economic growth with low interest rates and low inflation. Under these conditions, costs of goods and services and interest expenses stay low for State and local governments, while revenues from their own sources grow steadily to finance the projects that they consider important. The Administration's proposals are designed to set the stage for such economic growth. These proposals continue the tax cuts enacted last year and continue to eliminate unnecessary Federal Government spending and regulations. Some of this unnecessary spending included restrictive categorical grants to States and localities for which there was no justifiable Federal role.

Another way of aiding States and localities is to provide them with grants or tax resources that allow them considerable discretion in the use of the funds. This rationale resulted in the block grants that Congress enacted last year and in similar proposals for 1983, and is the major rationale for the Administration's Federalism initiative. This initiative would decrease some Federal taxes and let States and localities decide whether they wanted to assume those taxes as well as the programs included in the initiative.

A strong economy with more discretion by State and local governments over the use of Federal grant funds will decrease the dependency of States and localities on the Federal treasury and strengthen their proper role in our Federal system of government.

Question: Mr. Stockman: In testimony before the House Budget Committee last week you left the impression that the President was willing to compromise on the defense budget; that a defense cut of $10 billion might be entertained. Yet two weeks ago, and again last week during his press conference, President Reagan made it clear that the defense budget was not one of the areas open for negotiation or compromise. Do you stand behind the President's position on defense?

Answer: Yes.

Question: There is speculation in some quarters that the FY 1983 deficit problem can be solved by significant cuts in defense spending, particularly in sophisticated new weapons. Military considerations aside, could you explain why large reductions in weapons procurement and research and development will not result in any significant savings in FY 1983?

Answer: The outlays effect of any reduction to Defense budget authority depends on the nature and content of that reduction. For example, if reductions were made to procurement programs initiated in FY 1983, only small outlay savings would result from the cut (about 12% of the budget authority reduction) in the same year. This is because procurement programs spend over a period of years. If reductions were made to research and development programs, only about half of the budget authority reduction would be saved in outlays in the first year.

Question: One of the reasons our major weapons systems have traditionally experienced cost overruns is inefficient procurement policies. This year the Administration is presenting a defense program which aims at efficient economic production rates and more economical buy lots in an effort to reduce the per unit cost of major weapons systems. Isn't it true that if defense spending were significantly reduced in FY 1983 procurement would again be stretched out and these savings eliminated? Could you explain why cutting defense spending now would result in higher costs for weapons procurement?

Answer: Yes, it is true that cutting procurement will again force us into stretching production rates. Since a manufacturer's annual fixed costs would then be spread over a smaller number of systems, unit costs would again increase, and any potential savings from economical production rates would be lost. This will lead to higher costs and then to still lower quantities bought. We will find ourselves once again in the situation where cost overruns are a fact of life. This Administration is attempting to break out of that old cycle, and we will need the Congress' affirmation that uneconomical production rates are not good business and are not in the long-term interests of the U.S.

Question: The Administration has initiated several defense management policiess in FY 1983 and full funding of fixed costs, more efficient rates of procurement and program efficiencies. Please explain how these programs are tied together and what the implications of reductions in the defense request are for these initiatives?

Answer: The purpose of all of these initiatives is to ensure that the Department of Defense and the nation get the greatest capability possible from the least amount of resources. In this sense they are all tied together; this objective is the focus of all of the Administration's efforts to improve the Defense acquisition process and the management of Defense operations.

If significant reductions were made in the Defense request, then we would likely be forced back into the old ways of doing business - buying fewer systems at high unit costs and, in the long run, increasing the total costs to the government.

WRITTEN COMMITTEE QUESTIONS TO SECRETARY REGAN AND RESPONSES

1. QUESTION:

The Administration's economic projections show that you expect an average growth rate for fiscal years 1982-87 of 4.7%. This is lower than the 5.4% average for fiscal years 1961-66, which was the Kennedy tax cut recovery period. Your forecast of 5.7% real growth during the first four quarters of recovery is also lower than the postwar recovery average of 6.9%.

In a recent television interview (w/Dan Rather), President Reagan said that he was more optimistic than his budget forecast would indicate. Do you think the figures are pessimistic?

In picking your growth figure of 4.7% you seem to have chosen the average between your high and low growth alternatives. You reject the high growth rate of 5.9% with the reasoning that "there has never been a 22-quarter period when real growth has approached the 5.9% rate assumed in the high growth scenario...." Why did you use a 22-quarter period when this would include the historical economic downturns and recessions? Since the tax cuts are in place, we should have a better recovery period than in the past. Therefore, wouldn't a shorter period provide a better historical perspective? (Such as the first 4 quarters of recovery.)

ANSWER:

It is quite possible, given a stable anti-inflationary monetary policy, declining interest rates, and the continuation of the President's program, for the economy to do better than forecast. The public must be convinced that inflation is down to stay, that Congress is serious about spending restraint, and that the tax reforms we have enacted will be permanent and given a chance to increase the reward to added work, effort and saving. If these conditions are met, the economic recovery should be rapid. We have proposed, and the Congress has enacted, a long-run economic program designed to produce steady long-term growth. Once recovery begins, we hope for a prolonged expansion of far more than 22 quarters without a downturn.

2. QUESTION:

Mr. Regan, will you indicate what the current position of this Administration is with regard to the accelerated decontrol of natural gas and whether the Administration will submit any legislation pertaining to natural gas decontrol? If such legislation is submitted what is the position towards a windfall or severance tax on natural gas?

There have been rumors concerning the possibility of the Administration proposing an energy severance tax, primarily on natural gas, or an oil import fee. Would you indicate what the Department of Treasury revenue estimates would be for such proposals and what underlying assumptions have been used by the Department in calculating the revenue impact? (i.e., the level of the fee or rate of the severance, the net revenue potential compared to the gross, the effect on the windfall profits revenue estimates, the impact on U.S. oil imports)

ANSWER:

The Administration has decided not to seek accelerated decontrol of natural gas at this time.

The revenue and other effects of a severance tax or oil import fee would vary with the level and structure of the tax. No specific proposals have been put forward by the Administration, although there have been some proposals mentioned by members of Congress. As an example, one such case would give a feel for the numbers and concepts.

A $3 per barrel oil import fee, for example, might yield $7.5 to $8.0 billion per year. This includes higher windfall profits tax receipts from domestic oil, whose price would rise in step with the tax-induced increase in the price of imported oil. The fee would raise about $5.7 billion per year directly assuming oil imports of about 5.5 million barrels per day. Each dollar of price increase would add about $.7 billion in windfall profits taxes (WPT). This is a net WPT receipts figure, after allowance for the tax deductibility of the WPT for purposes of computing ordinary corporate income taxes. The higher oil prices would reduce oil demand and imports by about 280,000 barrels per day in the short run and perhaps 560,000 barrels per day in the long run. A tax on oil would have some depressing effect on real GNP and tax receipts, but the exact degree of offset would be difficult to estimate.

3. QUESTION:

Mr. Regan, your testimony to House Ways and Means stated that "It is preferable to close the remaining transitional deficits --by borrowing rather than by taxing. Taxes impose a larger cost in terms of reduced incentives for growth." If taxes impose a higher cost than borrowing, why do we bother to have taxes at all --why not simply borrow all the money to finance the government?

ANSWER:

Borrowing takes a portion of current national savings out of current national income (which equals current net output) to enable the government to gain command over a portion of current output. Taxing also enables the government to have at its disposal a portion of current output. Like borrowing, taxation reduces the supply of savings for investors to borrow by a substantial amount. However, there is a difference. In recent years, tax increases have generally taken the form of allowing inflation to push taxpayers into higher brackets, or allowing inflation to erode the value of depreciation allowances. The former reduces the value of incremental present or future wages and interest income; the latter reduces the rate of return on plant and equipment. The effect is to reduce the supply of labor, savings, plant and equipment, cutting down on future output. Thus, taxation often produces disincentives which adversely affect future output, as well as directing a portion of current output to the government. Federal borrowing creates debt that must be serviced, and this implies the future payment of taxes, but it need not require an increase in marginal tax rates, as long as economic growth produces an enlarged tax base. Thus, borrowing should have less adverse impact on future output than taxation.

Thus, in deciding how to cover the transitional deficits associated with the current recession, we feel it is better to borrow, while leaving the tax incentives in place for long-run growth, rather than to undo the structural tax reforms of the ERTA, which would choke off future expansion.

4. QUESTION:

The Administration proposes a number of tax increases (completed contract method of accounting, restricting the use of tax exempt bonds, etc.) These measures increase taxes and change incentives. Why is it that all of the Administration's tax increases seem to have no effect on incentives while everyone else's proposals have very bad effects on incentives?

ANSWER:

We have tried to avoid serious disincentive effects by concentrating our tax increase proposals on areas in which unusually generous tax provisions have produced unintended or uneven results that are inefficient and unfair. It is expected that the proposals will produce efficiency and equity gains that will offset the disincentives of the tax increase. The effect of a tax change on incentives is not always obvious. Nor can it be estimated precisely, because the analysis is complex and requires empirical information about the incremental response of the activity being taxed to changes in its marginal after-tax rate of return. Very often, the revenue estimate accompanying the tax change is a very poor guide to the extent of the disincentive.

5. QUESTION:

Secretary Regan, the Administration has proposed certain budget targets in terms of revenue and spending levels and deficits in the FY 1983 budget message.

Is any one of these targets, revenues, outlays, or the deficit level more important for the Congress to achieve than any other?

ANSWER:

The President's economic program is designed to reduce inflation and increase the real rate of economic growth. The President's budget is an integral part of his economic program and the outlay, revenue and deficit estimates are important elements of the total budget. Federal outlays are a key measure of the ultimate burden of government, because they measure resources diverted to the use of the federal government. The budget outlay estimates are based on the President's recommendations for slowing the growth of federal spending. This deceleration is essential for freeing the resources necessary for increased private investment to improve productivity and raise real economic growth. Taxes and borrowing are alternative ways of financing spending. Each has its drawbacks. But taxes, if poorly designed, can be more harmful to future growth than temporary borrowing. With a well-designed tax code, saving can be encouraged to cover temporary deficits and still finance investment and growth. The revenue estimates, in part, reflect the expected effects of the Economic Recovery Tax Act of 1981. It is important to distinguish between the structure of tax rates and the level of tax revenues. The tax rate reductions embodied in ERTA are essential for improving the level and stability of real after-tax returns to productive factors, thus providing incentives for increased rates of saving and investment and work effort which raise the growth rate of real output and revenues.

6. QUESTION:

If the Congress goes beyond the President in its attempt to reduce the budget deficit, can you recommend areas in which additional savings can be made?

ANSWER:

The President's budget is the result of many hours of careful analysis. It stands as the Administration's best possible proposal to Congress. It would not be prudent for me at this time to chip away piece-meal at the package. I would recommend that the Congress go through its process of developing a package and documenting the rationale behind it, as did the Administration. Then we can sit down together and discuss our differences in a systematic way. The Congress may want to consider additional asset sales and perhaps develop a consensus on entitlement changes in the context of continued low inflation. The Administration would be willing to examine all serious suggestions from the Congress.

7. QUESTION:

Let me be clear, is the deficit level in the President's budget a recommendation or a residual given certain taxing and spending policies? Does it make a difference whether or not the FY 1983 deficit is $100 billion or $50 billion?

ANSWER:

As I indicated in my answer to question 1, the revenue and outlay proposals are based on the specific tax cuts and outlay growth reductions that are fundamental parts of the structure of the President's economic policy. The difference between estimated outlays and receipts for any fiscal year is the estimated deficit. Of course, we would prefer the economy to be as strong as possible and to reduce the deficit as far as possible, given our tax and spending requirements.

The deficit is primairly the result--a residual if you will--of the recession's impact on outlays and receipts, given current spending programs and the existing tax code. We do not regard the deficit as a policy tool to be used deliberately to stimulate expansion. Deficits must be financed through borrowing, which makes them neutral as far as total public and private sector spending is concerned, or through money creation, which is inflationary, and which we are urging the Federal Reserve to avoid.

8. QUESTIONS:

In looking back at the 1970's I note that the economy is almost identical to the economy in 1974-1975 in almost every respect except interest rates.

1. Can you explain why interest rates are higher today?
2. Do you believe that expectations of future inflation as a result of large budget deficits play a role?

ANSWER:

Interest rates have been driven to record high levels by several years of high inflation. Excessive monetary expansion of previous years has added a substantial inflation premium to interest rates. The exceptionally volatile behavior of the money supply, inflation and interest rates over periods of several months in the past two years has led to disruptive swings in bond prices and the emergence of a so-called volatility premium or risk premium in excess of the inflation premium *per se*. Increased deficits would raise future inflation and interest rates only if monetized by the Federal Reserve. The Fed has pledged to reduce gradually the growth rate of the money supply to noninflationary levels. As the Fed demonstrates its determination and ability to meet its monetary targets in a steady fashion, the inflation and risk premiums in nominal interest rates will be reduced.

Interest Rates

1. QUESTION:

Why won't high interest rates cripple the economic recovery projected this year?

ANSWER:

The Administration would prefer that nominal interest rates be lower rather than higher. We expect that the Fed will succeed in implementing its announced policy of stable money growth--we hope in the upper third of its target range, about 5%--with gradual year-over-year reductions in that growth rate. Inflation will continue to come down in response to the Fed's successful implementation of its policy. As indicated in an answer to an earlier question, reduced actual and expected inflation will reduce the inflation and volatility premiums in nominal interest rates. In addition, the Administration expects increased savings in response to ERTA, and this will also tend to reduce interest rates. The Administration's expectations about money growth, inflation, saving, and interest rates are reflected in its forecast of a recovery in the second half of 1982. This forecast is similar to most other major forecasts, including CBO. Without stable monetary policies, higher interest rates would threaten recovery.

2. QUESTION:

Hasn't the Administration interest rate projection been substantially in error?

ANSWER:

Yes, prior to revision last summer. We had expected steadier monetary policy. By September, though, rates had begun to fall, and were down sharply from their peaks.

3. QUESTION:

Why have interest rates risen by 300 basis points and more at the very bottom of the recession?

ANSWER:

The recent upturn in interest rates in December and January, prior to their latest decline in February and March, was a reflection of market concern over the very rapid expansion of the money stock in December and January and what that might mean for credit market conditions and/or inflation. I must emphasize that interest rates have been rising with rapid money growth, and falling with slower money growth for some years now, contrary to the naive assumptions of older theories.

Tax Proposal

1. QUESTION:

Why was only $12.8 billion of revenue increases included in the President's $55.9 billion deficit reduction program for FY 1983?

ANSWER:

The Administration felt that it was inadvisable to propose major tax increases during a recession. No reputable school of economic thought holds that to be proper countercyclical strategy. Also, most of the deficit is due to recession and, thus, is a temporary problem. We do not want to make permanent structural changes in the tax code to deal with a temporary problem. At higher levels of employment, the new tax code will generate revenues in excess of 19 percent of GNP, which is as much as the Federal Government ought to be spending.

2. QUESTION:

Why were corporate tax increases used for 71 percent of the FY 1983 revenue increase?

ANSWER:

Given the tax changes contained in the ACRS portion of ERTA, there are a number of obsolete or unnecessary provisions in the corporate side of the tax code which should be changed. This will increase economic efficiency by reducing some of the excessively generous provisions of current law which favor some industries over others. On the individual side, the tax reductions are barely large enough to offset bracket creep and the social security tax increases. Given the modest nature of the personal income tax cuts, and the impact of bracket creep in pricing products made with American labor out of world markets, it was thought best to leave the personal tax reductions in place. However, some suggestions have been made to increase compliance with the tax laws by individuals as well as businesses.

3. QUESTION:

What proportion of the corporate tax reduction for FY 1983 from the 1981 Economic Recovery Tax Act is offset by these proposed corporate tax increases?

ANSWER:

As indicated in the background information accompanying your question, the FY 1983 proposed corporate tax increase equals 70% of the $13.1 billion reduction provided by ERTA. However, it is essential to note the structural differences between ERTA and the

FY 1983 proposals, which have concentrated on abuses to enhance economic efficiency. ACRS is a fundamental part of ERTA, and it provides an important incentive to invest. The current proposals leave the incentives in place, while 1) eliminating abuses and obsolete incentives, 2) improving tax collection and enforcement, and 3) providing enterprise zone tax incentives and miscellaneous efforts to charge users of various federal programs for the services they receive.

4. QUESTION:

Are there not significant revenue increasing measures available in excise taxes and the taxation of individuals as well?

ANSWER:

Yes there are, but in our judgment such increases are not fair given the sizeable offsets to the individual tax cuts from bracket creep and social security tax increases, and not wise given the effect of taxes on the cost of labor (the factor of production contributing the largest amount of value added) and personal saving.

Savings

1. QUESTION:

In the budget briefing of February 6, 1982, you implied that federal absorption of savings would range between ten and twenty percent. In testimony before this committee last September 16, Paul Volcker showed that this percentage was very nearly fifty percent. How do you explain the difference?

ANSWER:

There are various measures of savings. The National Income and Product Accounts shows gross private saving, which consists of personal saving and business saving. Net private saving is obtained from gross by deducting depreciation. Then, subtracting corporate retained earnings leaves private funds available to credit markets. The percent of saving or credit flows absorbed by government depends on which measure of saving is used. The point to note is that, whichever measure is used, the historical pattern is the same. Government absorption of savings rises in recessions and falls in recoveries. It was higher under all measures following the 1975 recession than projected in 1982-1983. Thus, although higher than we would like to see, government borrowing can be handled by projected savings flows with enough to spare for a strong rise in investment and real growth. Secretary Regan's statement referred to gross savings. In calendar 1982, we expect gross private saving to be about $542 billion, of which about $391 billion is business saving, and $151 billion is personal. Because of the recession, business saving shows an especially small year-over-year increase, and the federal government absorbs about 19% of the total, which is relatively large, but still manageable. For 1983, we project gross private saving of about $650 billion, with about 16% absorbed by the federal government. For 1984, we project about $740 billion in saving, with less than 13% absorbed by the government.

2. QUESTION:

Is the federal government currently "crowding out" private investment borrowing?

ANSWER:

As shown in the third chart of my prepared statement, the deficits will be manageable because of the growth of private sector saving.

Private saving resulting from normal year-over-year growth and the Economic Recovery Tax Act will be several times greater than the total borrowing requirement of the Federal Government in 1983 and 1984 and thereafter.

The net additions to total private saving are larger than the rise in the deficit. They will produce "crowding in" rather than "crowding out." This extra shot in the arm of capital markets will put downward pressure on interest rates. Even after financing the Federal deficit, there will be billions of additional dollars each year for private investment.

Normal year-to-year increases in saving exceed $40 billion each year. This will be supplemented by the additional personal savings and additional business retained earnings induced by the tax cuts.

Compared to 1981, private saving will be more than $60 billion higher in 1982, more than $170 billion higher in 1983, and more than $260 billion higher in 1984. Private saving was just under $480 billion in 1981. It will rise to more than $740 billion in 1984. Judging by the experience of previous recoveries, these estimates are quite reasonable.

3. QUESTION:

If we have the economic recovery forecast by the Administration and interest rates recede, why would savings increase?

ANSWER:

The question confuses nominal interest rates with real interest rates which, after tax, influence savings behavior at the margin. High nominal interest, due mostly to inflation and fully taxable, often yields a low or negative real after-tax return. Lower nominal interest, with less inflation and lower tax rates, can yield a higher real after-tax return to the saver.

4. QUESTION:

If interest rates stay high and the economic recovery is weak, wouldn't this so discourage investment that it won't matter how much savings we have?

ANSWER:

High rates of saving would reduce real interest rates and encourage investment, others things equal. The question as stated violates basic GNP accounting rules. Persistence of high nominal interest rates due to inflation or uncertain monetary policies would discourage both saving and investment. The two must be equal once government saving or dissaving is added in.

CUTTING TAX EXPENDITURE ENTITLEMENTS

Question:

In reading the budget, one can discover:

- That all entitlements (except social security) rose by 412% between 1970 and 1981.
- That total budget outlays rose by 235% between 1970 and 1981.

These are cited as reasons: (1) to cut the budget generally; and (2) to cut entitlements (other than social security) even more.

There is another group of subsidy programs, of uncontrolled entitlements that has grown by 387% between 1970 and 1981 that will not be cut back significantly in FY 1983. These uncontrollables will grow by at least $17 billion, or about 8% in FY 1983. It is more likely that their growth will approach $30-40 billion, or about 15-20%.

These programs are the $243 billion in revenue losses that are sometimes called tax expenditures. They provide a special tax break -- not available to everyone -- to businesses and individuals who take certain actions -- buy machinery, export goods, explore for oil, conserve energy. These are entitlements because everyone who does these things is entitled to have his taxes reduced -- there is no "cap" on the potential revenue loss.

At a time when Congress and the Administration are seeking "revenue raisers" and trying to cap spending programs -- why do we want to leave in place an automatic revenue reduction of $17 billion to $40 billion to businesses and individuals. Should we not seek to cap this also? Or at least to repeal more than the $2.7 billion in tax expenditures that the Administration has proposed in its budget?

Answer:

The Administration has proposed to restrict or eliminate a number of tax provisions that do not provide economic benefits commensurate with the foregone revenues. Some of these provisions, such as the business energy credits, would be included in your tax expenditure estimates, while some others (e.g. completed contract accounting) would not. In addition, the growth of many tax expenditures, as commonly measured, has also been reduced significantly by reducing the individual tax rates that determine the value of special deductions. Further reductions will be forthcoming as scheduled rate cuts are implemented.

The Administration will continue to examine outlays and receipts to reduce the burdens of both.

HOUSING INDUSTRY

Question

For 6 months now the annual rate of housing starts has been below the one million mark. For all of 1981, housing starts were below 1.1 million units, the lowest level since 1946. And for 1982, the National Association of Home Builders predicts an even worse year than 198

Interest rates are starting to climb again, threatening to prevent any recovery in the housing industry -- and perhaps in the whole economy. The prime rate is now up to 17%. And the credit markets are going to have to absorb deficits of $365 billion over the next five years.

For decades this country has had a housing policy which has sought to assure decent housing for all. That policy has sought to maximize home ownership. Now we appear to be facing an Administration effort to dismantle most federal housing programs and to permanently cripple the housing industry.

An article in the WALL STREET JOURNAL suggested that the Administratio has embarked on a deliberate program to favor industrial expansion at the expense of the housing industry.

The article quotes Robert S. Waill of the Home Insurance Company as suggesting that the Administration has made "a conscious decision to alter national priorities in favor of building up our defense and rejuvenating our corporations, even if that means de-emphasizing, at least temporarily, such other priorities as a high level of community services - and home ownership."

Certainly a look at the President's budget would seem to confirm this.

If we take a look at the credit budget we are told that federal loans and loan guarantees are bad because "Increasing demand for credit by the Government and the borrowers it serves saps the vitality of credit markets and hampers their performance in the critical task of allocating resources to the most productive uses." We are also told that federal credit programs have "...caused a misdirection of investment and a decline in economic growth."

One of the chief targets for reducing federal credit activities is the housing industry, with major changes affecting Ginnie Mae (Government National Mortgage Association), FHA, Farmers Home Administration and Public Housing.

When we turn to the tax side of the Administration's program, we learn that government intervention in private markets through the tax code is not so bad. In the Economic Report of the President there is the statement: "The 1981 (Tax) act will alter the allocation of existing capital and labor among industries. It will also affect the allocation of new business investment, the fraction of investment allocated to business as opposed to residential investment...." (emphasis supplied). So it is suggested that the Tax Act will divert investment from housing although the Report concedes that there may be strong demands for housing.

Finally, if one looks at the spending proposed in the budget, housing is also taking it on the chin. Specifically, the main program for direct stimulation of new housing construction under Section 8 is being abolished and $9.4 billion already appropriated for FY 1982 would be rescinded, along with $2.4 billion for FY 1983. There would be no new appropriations for new construction.

The budget submitted by President Reagan proposes a number of steps toward reducing assistance to housing:

- Reduce commitments to issue Ginnie Mae mortgage-backed securities from $48 billion in FY 1982 to $38.4 billion in FY 1983, a reduction of 20%. These instruments are the chief method of marketing FHA and VA loans. They have a negligible impact on budget spending.

- Terminate the Ginnie Mae tandem mortgage purchase program.

- Reduce loans for new rental housing for the elderly and the handicapped by 45%.

- Reduce loans for housing made through the Farmers Home Administration (FmHA) by 69%. These loans for new single family home owners and for rental properties would be reduced from $3.7 billion to $1.1 billion.

- Deregulate the interest rate on FHA-insured loans, probably resulting in higher rates.

- Terminate new construction of non-elderly housing units under Section 8 housing assistance programs.

Housing has traditionally been a leader out of recession. Clearly the Council of Economic Advisers expects this to continue when it says in its report:

"The key areas of rebound in the economy this year (1982) are expected to be consumer goods, housing, autos, and defense." (emphasis supplied)

Yet how can we expect housing to lead the way, when:

- Interest rates are still near all time highs and deficits will continue to push them up.
- Virtually every federal housing activity is severely reduced or terminated.
- The tax act can be expected to swing investment away from housing.
- When the savings and loan industry -- from which housing traditionally gets its funds -- is posting losses in the billions?

Answer

The strength of the housing sector depends heavily on the cost and availability of funds to finance home building and acquisition. A prolonged period of record high interest rates has had an impact on the housing industry. However, as overall economic conditions improve and interest rates decline in the second half of 1982, the housing sector should rebound from its depressed status. DRI, for example, forecasts 1982 housing starts to reach the 1.1 million range by mid year.

Interest rates have already receded from their recent high levels at the end of 1981. The prime rate is now 16-1/2 percent (rather than 17 percent as indicated in the question). Mortgage rates have dropped; the government insured rate recently fell from 16-1/2 percent to 15-1/2 percent. We expect further reductions over the coming months as inflation continues to slow and private saving rises as a result of tax reductions already in place and those that will take effect later this year. Lower interest rates will encourage households to reenter the housing market.

Some thrift institutions are experiencing difficulties because of the high interest rate structure. However, if interest rates decline as we expect them to this year and next, we are confident that the industry can rebound and strengthen its financial position. In addition, the saving incentives embodied in the Economic Recovery Tax Act of 1981 will increase the flow of savings to thrift institutions and enable them to compete more effectively for available funds. This will help the housing sector.

The objective of the Administration is to maximize the private financing of mortgage credit and to target Federal credit resources to those who are not adequately served by private credit markets. Thus, some current Federal housing programs are scaled back, as proposed in the FY 1982 budget, but those groups in greatest need will not suffer. At the same time, Federal and Federally assisted demands for credit will be reduced in order to help exert downward pressure on interest rates and increase the supply of funds available for private investors. The most important tool for reducing interest rates, however, is a moderate and steady growth of the money supply. If the Federal Reserve achieves that objective over a sustained period of time, we will see interest rates fall followed by a revival of the housing and construction sector.

WRITTEN COMMITTEE QUESTIONS TO DR. RIVLIN AND THE RESPONSES

Senator Chiles: Dr. Rivlin, you point out that it would be harmful to the economy to continue to run large and growing deficits during the next few years.

The problem facing us is How Much We Have to Get the Deficits Down. Each billion dollars of deficit reduction means a billion dollars' worth of political pain, and reduces the prospect of getting the package through Congress.

Your re-estimate of the President's budget shows that it would leave the deficit at about 3.5 percent of GNP from 1982 to 1985. Looking back over the last twenty years, we have mostly kept deficits at one to two percent of GNP except during the recession of 1975-1976. If we get the deficit down to 2 percent of GNP, are we o.k. or do we have to get it down to one percent?

Answer. The most worrisome aspect of the current budget outlook is that it shows the deficit rising in dollar terms as the economy recovers from the recession. If the Congress can succeed in shifting the growth pattern so the deficit falls as the economy recovers then it will also fall as a percentage of GNP. The important thing is to reverse the pattern of growing deficits.

Senator Chiles: The proponents of leaving the second and third round of tax cuts unchanged keep emphasizing the problem of "bracket creep" and the growing tax burden. I agree that we have to reduce the tax burden and reduce the share of GNP taken by government spending. But when we try to hold the taxpayer harmless by rate cuts or indexing, don't we have to balance that against two real sources of growth in the budget? First, we all agree we need a real increase in defense spending. Second, we know that the retired population depending on Social Security is growing, so don't we have to expect the real tax burden to grow by enough to cover those increases, minus whatever we can save on other domestic programs, if we are going to move toward a balanced budget? Would you please provide the Committee with figures on how much revenue we woulid have to raise to cover the President's real growth in defense and the real increase in retirement population?

Answer: The Congressional Budget Office estimates of the President's February 1982 request for defense (function 050) and Social Security are shown in the table below.

CBO ESTIMATES OF PRESIDENT'S FEBRUARY 1982 BUDGET FOR DEFENSE AND SOCIAL SECURITY (By fiscal year, in billions of dollars)

	1982	1983	1984	1985
Defense (function 050)	190.7	222.9	254.8	294.0
Social Security	157.6	174.4	190.8	207.7

Projected cumulative growth in outlays above 1982 levels for 1983-1985 is $199.6 billion in defense and $100.1 billion in Social Security. This totals $299.7 billion and represents, in nominal terms, the amount of revenues needed to fund the 1983-1985 projected real growth in defense and Social Security.

WRITTEN COMMITTEE QUESTIONS TO MR. WEIDENBAUM AND RESPONSES

Questions:

1. Are foreign governments (e.g., Sweden, Denmark, Finland, Venezuela, Canada, and Providences of Canada) borrowing directly in the U.S. by issuance of bonds and notes?

2. Are foreign governments (e.g., Sweden, etc.) borrowing directly from U.S. banks and syndicated loans?

Answer:

Yes, foreign governments are permitted to and do borrow in the U.S. capital market. The definition of foreign government entity would include government controlled companies as well as government in the narrow sense.

Questions:

3. Are foreign banks, backed by their governments, borrowing directly in the U.S. through the issuance of bonds and notes?

4. Are foreign banks borrowing directly in the U.S. through issuance of bonds, notes, and by syndicated bank loans?

Answer:

The definition of foreign banks can vary from the narrow one of those only under foreign control to a broad definition that includes foreign branches of U.S. resident banks. Foreign banks can borrow in the U.S. capital market, and frequently do. In some instances such borrowing may be supported by foreign government guarantees.

Question:

5. Is it possible for French banks who presently issue securities in the U.S. to tap tax-free pension funds to provide funding for the Russian-French gas line?

Answer:

Financial resources are always fungible. It is possible that a French bank could borrow funds in the U.S. and then finance the Russian-French gas line. Whether such borrowed funds are used directly for this purpose is almost impossible to trace. Pension funds determine the type of securities in which to invest depending on relative return and risk. If it were prudent to invest in French bank securities, the pension fund could choose to do so.

Questions:

6. Are equities of foreign business being registered, issued, and sold in the U.S. to pension funds to fund foreign construction outside of the U.S. to compete with U.S. business (e.g., Hiptil-Morgan Stanley registration)?

Answer:

Again, pension funds determine the kind of securities in which to invest depending on the characteristics of various securities, including relative return and risk. If it were prudent to invest in foreign equities the pension fund could choose to do so. Foreign borrowing of this sort should not be viewed solely in relation to the U.S. capital market, but should be analyzed in terms of worldwide demand and supply for capital.

Questions:

7. Does foreign borrowing in the U.S. affect the interest rates paid by U.S. consumers and the U.S. Treasury?

8. Are foreign countries who borrow in the U.S. in effect transferring their deficit to the U.S. economy?

9. Is foreign government borrowing and foreign business borrowing directly in the U.S. having the effect of "crowding out private borrowers" in the U.S.?

10. Does foreign borrowing in the U.S. have an impact on the interest rates for automotive loans and residential mortgages?

Answer:

For these four questions the same answer applies. With the increasing integration of world financial markets, the question of where funds are raised becomes of little importance. U.S. firms borrow heavily in foreign capital markets in seeking the best terms possible on their debt. It is best to view the capital markets of individual countries as part of a single world market. Hence, where foreign borrowing actually takes place is of little consequence for the issue of "crowding out."

Although it is true that government borrowing can have the effect of raising interest rates and thus "crowd out" private borrowers, it is the total level of government borrowing across all countries that is relevant and not where the borrowing occurs.

To the extent that total world borrowing exceeds total world saving there will be upward pressure on interest rates. This pressure is not, however, due per se to foreign borrowing in the U.S. market. Rather, upward pressure on interest rates is a function of total world demand for and supply of funds.

WRITTEN COMMITTEE QUESTIONS TO MR. ROBERTS AND RESPONSES

Question

There has been much criticism that the Reagan Economic Recovery Plan has not worked, and that "supply-side" economics has failed. I am sure that you would agree with me that this is incorrect, since the Reagan plan has yet to go into effect. The Reagan plan would have a 20% tax cut in place now, as opposed to the 5% we have.

In your testimony you point out that even with the personal tax rate reductions enacted into law, revenues as a percent of GNP will be 20.3% this year compared to 19.1% in 1977 and 19.7% in 1979.

It is a major point of our economic recovery plan that the negative effects of tight money can be off-set by the positive effects of marginal tax cuts. The revenue figures show that no such offset is likely to occur.

With this in mind, what would you think of accelerating the third year of the personal rate reductions from July to January, as originally planned by the President?

In your testimony, you expressed doubt that we will see an economic recovery this year. Would accelerating the tax cut help spur us into a recovery? If so, when would you expect this to occur? If not, then what would you suggest?

Answer

In principle President Reagan has a supply-side economic policy. In practice he does not. If supply-side economics had been implemented, instead of pushed to the back burner, the recession and the large budget deficits caused by the recession could have been avoided. It bodes ill for the economy and the taxpayer when supply-side economics is blamed for a recession it would have prevented.

The danger now is that the opponents of tax reduction will make the deficit, rather than the recession, the focus of economic policy. If policymakers respond to a faltering economy with austerity measures such as higher taxes, they may widen the recession and increase the deficits.

Restoring the original schedule for the third year of the personal tax rate reductions by moving them to January 1983 from July 1983 would reassure the economy that the government at least understood that the economy was in a recession. It may have a broader effect as well. When OMB succeeded in forcing the Administration to forecast large budget deficits, OMB guaranteed that interest rates would remain high--not because of perceived financing problems, but for real and fundamental reasons. The Stockman deficit projections signaled to the markets that spending was out of control. This told the markets that the tax cuts, which had been delayed, were vulnerable. And that told them that the Reagan revolution might loose out to business as usual. Accelerating the tax cuts would be a way of signaling the economy that the government intends to see the policy revolution through to success. Once the markets believe that there is actually going to be a supply-side policy in practice, and not just in rhetoric, the economy will perform better, and the deficits will decline as the economy grows.

ANALYSIS OF STATE-BY-STATE FISCAL IMPACT OF PRESIDENT REAGAN'S 1983 BUDGET PROPOSALS

Intergovernmental Fiscal Analysis Project
The University of Michigan
February 19, 1982

We have today completed a preliminary analysis of the state-by-state fiscal impact of President Reagan's 1983 budget proposals. Our estimates of impact are based on the concept of "budget resources available." This concept differs from the concept of "budget authority" found in official U.S. Government documents in the following ways:

1. The value of loans guaranteed, insured or offered directly to borrowers is included in our totals.

2. We include some, but not all, of the so-called "off budget" expenditures in our totals.

3. Approximately $30 billion in budget authority is excluded from our totals due to absence of agency reports.

Because of these differences, our figures are substantially higher than the "budget authority" figures reported in 1983 budget documents. On the other hand, our figures are roughly similar to the combined total of "budget authority" and "federal credit budget" sums found in budget documents. Our use of "resources available" is intended to summarize the total benefits made available to American citizens from federal fiscal actions. We believe that this is the most significant economic meaning of federal budget policies.

Unless otherwise noted, all figures used in the following tables are taken from the Appendix to the 1983 Budget of the United States. State shares, by function or program, are based on each state's average receipt of federal funds for each of 500 unique Treasury Accounts, for the three-year period 1978-1980. Program shares are based on average outlays, to individual states, from individual program accounts and then aggregated to subfunction and function totals for summary statistics. Figures for actual 1981, estimated 1982 and proposed 1983 expenditures were recorded on computer tape, and estimates of state receipts were derived by applying previously-calculated state shares to these 1981, 1982 and 1983 totals. The estimates, therefore, should not be taken as exact representations of state receipts, but rather the best possible estimates of receipts, assuming current and future outlays similar to average outlays during the 1978-80 period.

Major potential biases in these estimates include the following:

1. Past patterns of loan guarantees or insured loans may be subverted by unusual population movements to the South and Southwest; if so, estimates of change in the Northeast and North Central regions may be overstated and estimates of change in other regions may be understated.

2. Since defense expenditure increments include large amounts for shipbuilding, estimates of change may understate the impact of President Reagan's proposals on shipbuilding states such as Maine, Connecticut or Louisiana, while overstating the impact on California or Texas.

A. The 1983 Budget, By Function

Table One shows actual 1981 expenditures, 1983 proposed expenditures, the difference between these sums and the percent change, by major budget function. Several conclusions emerge clearly from this table:

1. Federal budget resources available increase by nearly 17 percent in the proposed 1983 budget, compared to 1981 expenditures ($814.8 to $952.6 billion).

2. Proposed expenditures for national defense increase by 42 percent ($78.9 billion) in fiscal 1983, followed closely by a 40 percent increase in proposed spending for interest on the national debt. Other functional increases in general government, science-space-technology or international affairs are similar to the overall increase of 17 percent.

3. Reductions in proposed federal expenditures for Energy (-32 percent), Community and Regional Development (-23 percent) and Education-Training-Social Services (-23 percent) comprise the bulk of federal spending reductions.

B. The Distribution of Gains and Losses, By Function

Table Two reports dollar and per capita differences between 1981 actual and 1983 proposed expenditures for several major budget functions, including National Defense, Energy, Agriculture, Transportation, Community and Regional Development, Education, Training, Employment and Social Services, and all other functions. The District of Columbia is excluded from regional and national totals in order to avoid artificial inflation of the sums allocated to the South. From Table Two it is clear that,

1. The 1983 Budget proposes substantial resource increases for all regions, with the Northeast gaining the most in absolute dollars ($40.8 billion) and the West gaining the largest per capita increase ($833).

2. As in the past, the North Central region lags well behind other regions in net dollar increases proposed, falling $7 billion behind the West, $11.5 billion behind the South and $15.4 billion behind the Northeast. In per capita terms the North Central area receives hardly more than half of the sums proposed for the West and the Northeast, and is considerably short of per capita allocation proposed for the South.

3. The North Central area receives the smallest resource increment primarily because proposed spending for National Defense is far smaller in this region than elsewhere. Dollar and per capita losses in the Energy, Agriculture and Social Service functions are smaller in the North Central region than elsewhere, but the defense increase is far less in general and only 40 percent of the Defense increment allocated to the West (in per capita terms).

4. Hard-pressed states such as Michigan (see Appendix Table One for a listing of all states and regions) suffer large losses ($312 million) in social service dollars, as well as less generous defense increments. In per capita terms, Michigan's proposed defense allocation is only 52 percent of the national per capita average and its total increment of $407 is only 66 percent of the national per capita average of $619.

5. These differences in proposed increases in budget resources tend to exaggerate existing federal funding disparities. Appendix Maps 1, 2, and 3 show these disparities clearly by estimating total per capita spending, by state, for 1982 and 1983, and per capita growth in budget resources available for the 1981-83 period.

C. The Distribution of Program Changes

In Table 3 we report program dollar losses for Census Divisions and the nation as a whole in the following programs: Food Stamps, CETA, Highway Assistance, Subsidized Housing Assistance, Student Aid, AFDC and Medicaid. It is apparent from these figures that,

1. The South Atlantic, Mid-Atlantic and East North Central States suffer the largest losses in food stamp allocations.

2. CETA funding losses are concentrated in the Mid-Atlantic, East North Central and Pacific areas.

3. Highway funding losses are particularly heavy in the Pacific and East North Central areas.

4. Large losses in subsidized housing assistance will be experienced in the Mid-Atlantic, East North Central and South Atlantic areas.

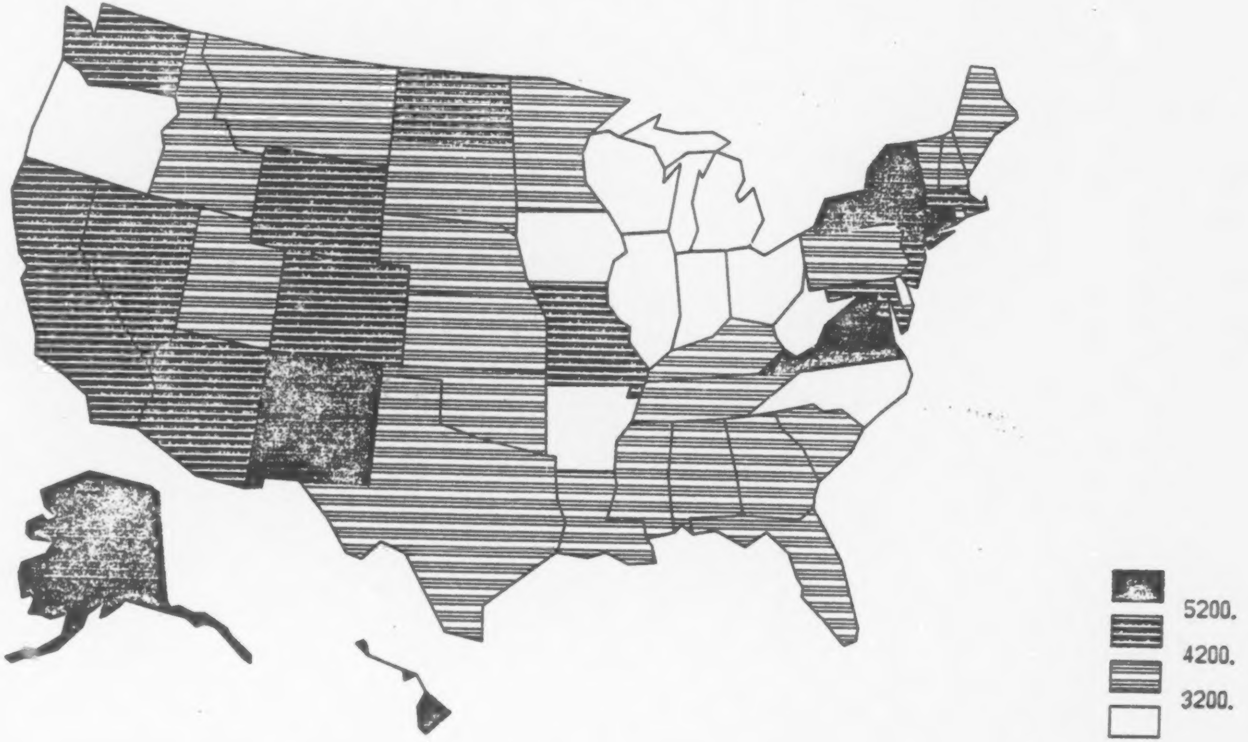
5. Student financial assistance, primarily Pell grants and work-study funds, will be reduced most severely in the Mid-Atlantic and East North Central areas.

6. Substantial reductions in funding for AFDC and Medicaid will be concentrated in the Mid-Atlantic, East North Central and Pacific divisions.

7. For these programs as a whole, losses in funding will be especially severe in the Mid-Atlantic and East North Central divisions.

APPENDIX MAP ONE

PER CAPITA BUDGET AUTHORITY FUNDING: FY82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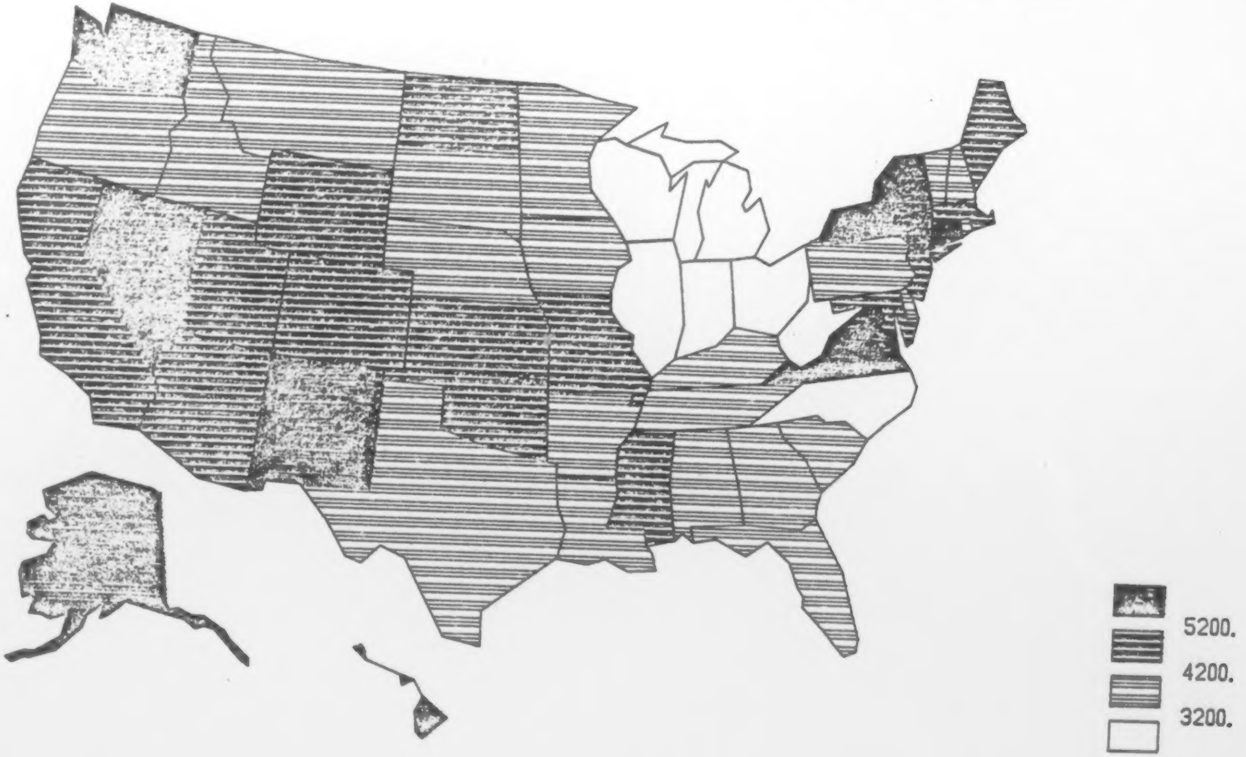
APPENDIX MAP TWO

PER CAPITA BUDGET AUTHORITY FUNDING: FY83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APPENDIX MAP THREE

PER CAPITA GROWTH IN BUDGET AUTHORITY: FY81 TO FY83

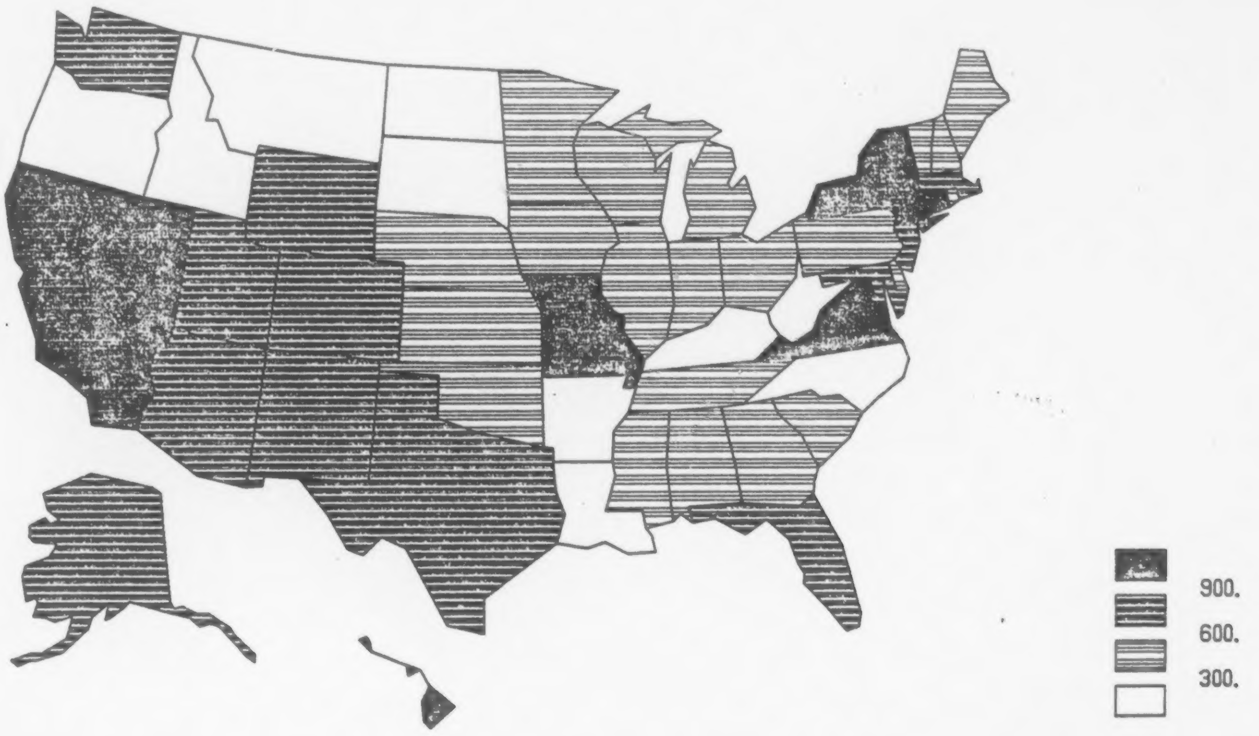

TABLE ONE

CHANGES IN BUDGET FUNCTIONS, 1981 - 1983

		Actual Expenditure 1981	Proposed Expenditure 1983	Change in Dollars	% Change
50.	National Defense	186792415.	265663966.	78871551.	42%
150.	International Affairs	8408621.	9493971.	1085350.	13
250.	General Science, Space, and Technology	7063372.	8291953.	1228581.	17.4
270.	Energy	15258885.	10362421.	-4896464.	-32
300.	Natural Resources and Environment	12086744.	11558505.	-528239.	-.04
350.	Agriculture	15653861.	12924774.	-2729087.	-17
370.	Commerce and Housing Credit	50436354.	61483852.	11047498.	22
400.	Transportation	22343377.	18900896.	-3442481.	-15
450.	Community and Regional Development	10799627.	9364282.	-1435345.	-23
500.	Education, Training, Employment, Social Svcs.	33150475.	25581583.	-7568892.	-23
550.	Health	71336182.	80653583.	9317401.	13
600.	Income Security	234342180.	239860844.	5518664.	.02
700.	Veterans Benefits and Svcs.	34437072.	46092308.	11655236.	.07
750.	Administration of Justice	2675735.	2875827.	200092.	.08
800.	General Government	8423127.	9923927.	1500800.	18
850.	General Purpose Fiscal Assistance	5145152.	4771265.	-373887.	-.07
900.	Interest	96465467.	134836700.	38371233.	40
999.	Totals	814818646.	952640657.	137822011.	17
	Minus Interest:	718353179.	817803957. (16.9% increase)		

TABLE TWO

1981-83 Dollar (millions) and Per Capita Differences, By Function & Region

1981-83 Dollar Differences, Millions, By Region

	Defense	Energy	Agric.	Transp.	Comm. & Reg. Dev.	Ed. & Soc. Serv.	Other	Total
N. E.	18,217	-302	-143	-819	-294	-1442	25,566	40,782
N. Ct.	12,723	-1004	-601	-593	-370	-1540	16,729	25,344
South	24,009	-2487	-1571	-646	-285	-2353	20,502	36,844*
West	21,582	-898	-455	-561	-369	-1754	16,192	33,737
1981-83 Per Capita Differences, By Region								
N. E.	363	-6	-3	-16	-6	-29	509	812
N. Ct.	216	-17	-10	-10	-6	-26	284	430
South	337	-35	-22	-9	-4	-33	283	516
West	533	-22	-11	-14	-9	-43	400	833
Michigan, $	1702	-44	-77	-60	-61	-312	2688	3837
Per Cap.	180	-5	-8	-6	-6	-33	285	407
Nation, $	76,530	-4691	-2770	-2620	-1318	-7089	78,990	136,707*
Nation, PC	346	-21	-13	-12	-6	-32	356	619

*DC Excluded

TABLE THREE

Program Changes 1981-83, By Census Division, In Total and Per Capital Dollars

Dollar Changes, Millions

	Food Stamps	CETA	Highways	Subsidized Housing	Student Aid	AFDC	Medicaid
New England	-91	-273	-59	-2065	-148	-179	-334
Mid.-Atl.	-296	-844	-142	-5884	-390	-669	-1097
E. N. C.	-278	-772	-181	-4006	-306	-536	-773
W. N. C.	-71	-253	-119	-1662	-163	-144	-294
S. Atl.	-324	-669	-239	-3593	-260	-239	-504
E. S. C.	-189	-303	-90	-1718	-137	-102	-286
W. S. C.	-205	-384	-121	-2224	-169	-114	-439
Mountain	-69	-276	-105	-924	-90	-63	-109
Pacific	-186	-723	-171	-2140	-233	-532	-638
Nation	-1719	-4626	-1241	-24429	-1916	-2600	-4503

APPENDIX TABLE 1.

PER CAPITA BUDGET RESOURCES BY MAJOR FUNCTION

CHANGES IN SPENDING FY81 TO FY83

	Nat. Def.	Energy	Agric.	Trans.	Comm. Reg. Dev.	Educ. Train Empl. Soc. Svcs.	Other	Total
ALA...	251.	-5.	-25.	-4.	7.	-36.	244.	433.
ALK...	990.	-182.	-0.	-37.	-9.	-158.	66.	670.
ARZ...	392.	-3.	-20.	-11.	-8.	-50.	506.	806.
ARK...	109.	-18.	-56.	-24.	-14.	-40.	208.	164.
CAL...	627.	-9.	-6.	-7.	-9.	-40.	403.	960.
COL...	329.	-53.	-11.	-22.	-8.	-32.	541.	746.
CONN..	1187.	-7.	-0.	-8.	-5.	5.	407.	1578.
DEL...	307.	-3.	-4.	-8.	-5.	-29.	228.	487.
D.C...	2169.	-272.	82.	-729.	-115.	-341.	467.	1260.
FLA...	277.	-13.	-7.	-9.	-6.	-26.	465.	681.
GA....	264.	-17.	-44.	-10.	-17.	-37.	212.	352.
HA....	706.	-1.	-2.	2.	-5.	-42.	302.	960.
IDA...	203.	-50.	-100.	-10.	-22.	-44.	288.	265.
ILL...	106.	-14.	-5.	-21.	2.	-24.	266.	311.
IND...	234.	-20.	-12.	-4.	-5.	-27.	294.	460.
IOWA..	117.	-15.	-3.	-10.	-37.	-15.	360.	398.
KAN...	337.	-29.	-5.	-9.	-13.	-20.	328.	587.
KY....	142.	-70.	-19.	-5.	12.	-37.	182.	205.
LA....	176.	-130.	-33.	-23.	-14.	-36.	165.	105.
MAINE.	430.	-2.	-28.	-5.	-20.	-39.	242.	578.
MD....	498.	-40.	-3.	-21.	-6.	-32.	341.	737.
MASS..	548.	-7.	-1.	-26.	-16.	-35.	277.	740.
MI....	180.	-5.	-8.	-6.	-6.	-33.	285.	407.
MINN..	240.	-24.	-6.	-14.	-9.	-25.	290.	452.
MISS..	469.	-19.	-89.	-4.	-34.	-44.	217.	497.
MO....	710.	-26.	-9.	-6.	-1.	-29.	289.	928.
MONT..	114.	-35.	-40.	-18.	-18.	-62.	219.	160.
NEB...	151.	-13.	-37.	-9.	-11.	-11.	312.	383.
NEV...	461.	-33.	-9.	-15.	-5.	-41.	675.	1033.
N.H...	386.	-4.	-2.	-1.	-14.	-27.	253.	591.
N.J...	228.	-8.	-1.	-6.	-5.	-16.	631.	823.
N.M...	694.	-88.	-19.	-15.	-19.	-57.	279.	775.
N.Y...	294.	-4.	-3.	-14.	-0.	-45.	765.	993.
N.C...	193.	-2.	-14.	-4.	-10.	-36.	156.	283.
N.D...	243.	-61.	-64.	-23.	-16.	-21.	228.	287.
OHIO..	189.	-20.	-3.	-7.	-6.	-29.	265.	390.

APPENDIX TABLE 1.

PER CAPITA BUDGET RESOURCES BY MAJOR FUNCTION

(continued)

OKLA..	265.	-53.	-50.	4.	-9.	-40.	293.	409.
ORE...	80.	-22.	-14.	-14.	-8.	-44.	284.	263.
PA....	242.	-8.	-3.	-26.	-7.	-16.	267.	448.
R.I...	279.	-1.	-1.	-8.	-14.	-28.	223.	451.
S.C...	317.	-8.	-16.	-3.	-22.	-37.	225.	456.
S.D...	114.	-78.	-142.	-16.	-17.	-32.	157.	-14.
TENN..	177.	-71.	-13.	-4.	132.	-31.	243.	434.
TEX...	496.	-11.	-18.	-12.	-26.	-28.	326.	727.
UTAH..	307.	-10.	-7.	-11.	-5.	-43.	436.	666.
VER...	251.	-2.	-21.	-13.	-14.	-37.	190.	354.
VA....	763.	-113.	-11.	-3.	-5.	-32.	352.	951.
WASH..	647.	-46.	-6.	-54.	-14.	-46.	354.	836.
W.VA..	61.	-8.	-7.	-6.	-38.	-40.	192.	155.
WIS...	94.	-6.	-18.	-7.	-5.	-21.	296.	331.
WY....	186.	-97.	-62.	-22.	46.	-31.	641.	661.
N.ENG.	657.	-6.	-4.	-16.	-13.	-24.	298.	891.
M.A...	264.	-6.	-2.	-16.	-3.	-30.	580.	786.
E.N.C.	160.	-13.	-8.	-10.	-4.	-28.	277.	375.
W.N.C.	354.	-26.	-17.	-10.	-13.	-23.	301.	567.
S.A...	354.	-29.	-15.	-8.	-11.	-32.	307.	566.
E.S.C.	238.	-44.	-31.	-4.	40.	-36.	224.	387.
W.S.C.	371.	-38.	-28.	-13.	-21.	-32.	281.	520.
MOUNT.	360.	-38.	-25.	-15.	-9.	-45.	457.	685.
PAC...	593.	-17.	-7.	-13.	-9.	-43.	380.	864.
N.E...	363.	-6.	-3.	-16.	-6.	-29.	509.	812.
N.CT..	216.	-17.	-10.	-10.	-6.	-26.	284.	430.
SOUTH.	337.	-35.	-22.	-9.	-4.	-33.	283.	516.
WEST..	533.	-22.	-11.	-14.	-9.	-43.	400.	833.
NAT.65	346.	-21.	-13.	-12.	-6.	-32.	356.	619.

APPENDIX TABLE 2.

MAJOR PROGRAM SPENDING CHANGES FY81 to FY83

DOLLAR AMOUNTS IN MILLIONS

	Food Stamp	CETA	Fed. Aid Highways	Subsidized Housing	Student Financ. Asst.	AFDC	Medicaid
ALA...	-48.	-75.	-27.	-537.	-39.	-25.	-68.
ALK...	-5.	-27.	-16.	-37.	-1.	-5.	-6.
ARZ...	-18.	-77.	-21.	-178.	-23.	-8.	0.
ARK...	-27.	-46.	-14.	-252.	-18.	-15.	-58.
CAL...	-128.	-512.	-77.	-1561.	-167.	-430.	-315.
COL...	-16.	-50.	-22.	-218.	-23.	-17.	-34.
CONN..	-14.	-58.	-12.	-485.	-20.	-35.	-58.
DEL...	-4.	-13.	-4.	-78.	-4.	-6.	-7.
D.C...	-10.	-130.	-15.	-214.	-22.	-21.	-28.
FLA...	-91.	-174.	-47.	-707.	-63.	-45.	-78.
GA....	-56.	-108.	-39.	-656.	-36.	-34.	-104.
HA....	-13.	-23.	-9.	-102.	-5.	-17.	-16.
IDA...	-5.	-25.	-7.	-54.	-7.	-6.	-12.
ILL...	-94.	-187.	-58.	-1480.	-83.	-141.	-206.
IND...	-30.	-119.	-24.	-410.	-39.	-30.	-71.
IOWA..	-12.	-30.	-20.	-126.	-30.	-27.	-43.
KAN...	-7.	-24.	-18.	-173.	-21.	-17.	-34.
KY....	-46.	-88.	-25.	-429.	-28.	-36.	-72.
LA....	-54.	-73.	-23	-479.	-36.	-34.	-95.
MAINE.	-12.	-25.	-7.	-146.	-15.	-15.	-35.
MD....	-32.	-91.	-47.	-552.	-31.	-42.	-67.
MASS..	-48.	-146.	-25.	-1009.	-80.	-100.	-183.
MI....	-54.	-196.	-35.	-737.	-69.	-187.	-212.
MINN..	-14.	-63.	-28.	-468.	-42.	-43.	-108.
MISS..	-36.	-63.	-12.	-239.	-30.	-17.	-60.
MO....	-29.	-89.	-27.	-527.	-36.	-38.	-64.
MONT..	-4.	-29.	-12.	-109.	-7.	-4.	-14.
NEB...	-4.	-20.	-10.	-141.	-14.	-10.	-23.
NEV...	-3.	-18.	-9.	-101.	-3.	-3.	-7.
N.H...	-5.	-12.	-6.	-131.	-11.	-6.	-15.
N.J...	-54.	-174.	-21.	-1141.	-48.	-107.	-130.
N.M...	-17.	-38.	-12.	-163.	-14.	-11.	-17.
N.Y...	-157.	-441.	-77.	-3358.	-235.	-383.	-722.
N.C...	-51.	-102.	-28.	-673.	-49.	-40.	-93.
N.D...	-2.	-12.	-8.	-93.	-8.	-3.	-10.
OHIO..	-86.	-197.	-42.	-1022.	-73.	-111.	-150.

MAJOR PROGRAM SPENDING

DOLLAR AMOUNTS IN MILLIONS

(continued)

OKLA..	-16.	-63.	-14.	-457.	-25.	-24.	-66.
ORE...	-18.	-63.	-22.	-148.	-27.	-35.	-38.
PA....	-84.	-228.	-44.	-1385.	-106.	-174.	-244.
R.I...	-7.	-21.	-4.	-221.	-13.	-14.	-29.
S.C...	-37.	-53.	-13.	-258.	-28.	-19.	-57.
S.D...	-4.	-16.	-8.	-143.	-11.	-5.	-13.
TENN..	-58.	-77.	-27.	-513.	-39.	-24.	-86.
TEX...	-109.	-202.	-69.	-1037.	-90.	-41.	-220.
UTAH..	-4.	-33.	-13.	-52.	-12.	-11.	-22.
VER...	-4.	-11.	-5.	-73.	-9.	-8.	-15.
VA....	-31.	-84.	-37.	-487.	-36.	-37.	-72.
WASH..	-22.	-98.	-47.	-292.	-33.	-45.	-63.
W.VA..	-21.	-45.	-24.	-182.	-13.	-17.	-26.
WIS...	-15.	-72.	-22.	-356.	-42.	-67.	-135.
WY....	-1.	-6.	-6.	-30.	-2.	-2.	-2.
N.ENG.	-91.	-273.	-59.	-2065.	-148.	-179.	-334.
M.A...	-296.	-844.	-142.	-5884.	-390.	-669.	-1097.
E.N.C.	-278.	-772.	-181.	-4006.	-306.	-536.	-773.
W.N.C.	-71.	-253.	-119.	-1662.	-163.	-144.	-294.
S.A...	-324.	-669.	-239.	-3593.	-260.	-239.	-504.
E.S.C.	-189.	-303.	-90.	-1718.	-137.	-102.	-286.
W.S.C.	-205.	-384.	-121.	-2224.	-169.	-114.	-439.
MOUNT.	-69.	-276.	-105.	-924.	-90.	-63.	-109.
PAC...	-186.	-723.	-171.	-2140.	-233.	-532.	-638.
N.E...	-387.	-1117.	-200.	-7949.	-537.	-848.	-1431.
N.CT..	-349.	-1025.	-300.	-5667.	-468.	-680.	-1067.
SOUTH.	-718.	-1356.	-450.	-7535.	-566.	-456.	-1230.
WEST..	-255.	-998.	-276.	-3064.	-323.	-595.	-747.
NAT.65	-1719.	-4626.	-1241.	-24429.	-1916.	-2600.	-4503.

BUDGET RESOURCES BY MAJOR FUNCTION

DOLLAR AMOUNTS IN MILLIONS

	Nat. Def.	Energy	Agric.	Trans.	Comm. Reg. Dev.	Educ. Train Empl. Soc. Svcs.	Other	Total
ALA...	934.	-20.	-93.	-13.	26.	-134.	907.	1607.
ALK...	388.	-71.	-0.	-14.	-4.	-62.	26.	263.
ARZ...	976.	-7.	-50.	-28.	-19.	-126.	1259.	2007.
ARK...	239.	-40.	-123.	-53.	-31.	-88.	456.	360.
CAL...	14141.	-197.	-136.	-153.	-201.	-907.	9090.	21636.
COL...	911.	-146.	-29.	-60.	-22.	-90.	1497.	2061.
CONN..	3804.	-22.	-1.	-25.	-18.	16.	1305.	5059.
DEL...	188.	-2.	-3.	-5.	-3.	-17.	139.	298.
D.C...	1509.	-189.	57.	-508.	-80.	-238.	325.	877.
FLA...	2573.	-117.	-64.	-84.	-59.	-241.	4329.	6337.
GA....	1306.	-90.	-231.	-51.	-87.	-193.	1117.	1052.
HA....	658.	-1.	-2.	2.	-5.	-39.	281.	894.
IDA...	176.	-43.	-86.	-9.	-19.	-38.	249.	230.
ILL...	1212.	-159.	-61.	-234.	26.	-275.	3025.	3534.
IND...	1272.	-111.	-65.	-20.	-26.	-144.	1598.	2504.
IOWA..	338.	-42.	-9.	-27.	-107.	-43.	1038.	1147.
KAN...	779.	-68.	-11.	-22.	-31.	-47.	758.	1350.
KY....	497.	-244.	-67.	-18.	42.	-129.	637.	716.
LA....	690.	-511.	-132.	-92.	-53.	-141.	649.	411.
MAINE.	470.	-2.	-30.	-5.	-22.	-43.	265.	632.
MD....	2190.	-178.	-14.	-92.	-28.	-140.	1501.	3239.
MASS..	3271.	-42.	-6.	-157.	-93.	-211.	1652.	4415.
MI....	1702.	-44.	-77.	-60.	-61.	-312.	2688.	3837.
MINN..	969.	-96.	-26.	-55.	-35.	-102.	1171.	1825.
MISS..	1123.	-45.	-212.	-9.	-82.	-104.	521.	1192.
MO....	3466.	-129.	-43.	-29.	-7.	-141.	1412.	4529.
MONT..	87.	-27.	-30.	-14.	-14.	-48.	167.	123.
NEB...	238.	-20.	-58.	-14.	-18.	-17.	491.	603.
NEV...	299.	-22.	-6.	-10.	-3.	-26.	438.	670.
N.H...	336.	-3.	-2.	-1.	-12.	-24.	220.	514.
N.J...	1734.	-61.	-9.	-42.	-41.	-121.	4797.	6258.
N.M...	832.	-105.	-23.	-17.	-23.	-69.	334.	929.
N.Y...	5320.	-77.	-46.	-261.	-5.	-822.	13842.	17952.
N.C...	1104.	-11.	-83.	-23.	-58.	-203.	892.	1619.
N.D...	153.	-38.	-40.	-14.	-10.	-13.	143.	181.
OHIO..	2072.	-214.	-30.	-72.	-65.	-322.	2896.	4264.

BUDGET RESOURCES BY MAJOR FUNCTION

DOLLAR AMOUNTS IN MILLIONS

(continued)

OKLA..	751.	-150.	-143.	11.	-25.	-114.	829.	1160.
ORE...	194.	-53.	-34.	-34.	-20.	-106.	693.	641.
PA....	2887.	-94.	-39.	-314.	-83.	-192.	3177.	5343.
R.I...	269.	-1.	-1.	-8.	-13.	-27.	214.	433.
S.C...	943.	-24.	-47.	-10.	-65.	-110.	671.	1357.
S.D...	77.	-53.	-95.	-11.	-12.	-21.	106.	-9.
TENN..	770.	-309.	-58.	-17.	576.	-134.	1058.	1884.
TEX...	6494.	-139.	-230.	-163.	-345.	-363.	4273.	9527.
UTAH..	397.	-13.	-9.	-14.	-7.	-56.	564.	863.
VER...	125.	-1.	-10.	-7.	-7.	-18.	94.	176.
VA....	4015.	-592.	-60.	-16.	-24.	-169.	1851.	5005.
WASH..	2450.	-175.	-24.	-203.	-51.	-175.	1341.	3163.
W.VA..	110.	-14.	-12.	-11.	-68.	-72.	347.	280.
WIS...	445.	-30.	-85.	-35.	-25.	-102.	1402.	1571.
WY....	73.	-38.	-24.	-8.	18.	-12.	250.	258.
N.ENG.	8275.	-71.	-50.	-203.	-165.	-307.	3750.	11229.
M.A...	9942.	-231.	-94.	-617.	-129.	-1135.	21817.	29553.
E.N.C.	6703.	-557.	-318.	-421.	-151.	-1155.	11610.	15711.
W.N.C.	6020.	-447.	-283.	-172.	-219.	-385.	5119.	9633.
S.A...	12511.	-1029.	-512.	-291.	-393.	-1146.	10847.	19987.
E.S.C.	3324.	-618.	-431.	-58.	561.	-502.	3123.	5399.
W.S.C.	8174.	-840.	-627.	-297.	-454.	-705.	6207.	11458.
MOUNT.	3751.	-400.	-259.	-159.	-89.	-464.	4760.	7140.
PAC...	17831.	-497.	-197.	-402.	-280.	-1290.	11432.	26597.
N.E...	18217.	-302.	-143.	-819.	-294.	-1442.	25566.	40782.
N.CT..	12723.	-1004.	-601.	-593.	-370.	-1540.	16729.	25344.
SOUTH.	24009.	-2487.	-1571.	-646.	-285.	-2353.	20178.	36844.
WEST..	21582.	-898.	-455.	-561.	-369.	-1754.	16192.	33737.
NAT.65	76530.	-4691.	-2770.	-2620.	-1318.	-7089.	78665.	136707.

Major Program Spending

Per Capita Amounts

	Food Stamps	CETA	Fed. Aid Highways	Subsidized Housing	Student Fin. Asst.	AFDC	Medicaid
ALA...	-13.	-20.	-7.	-145.	-11.	-7.	-18.
ALK...	-12.	-70.	-40.	-94.	-4.	-14.	-15.
ARZ...	-7.	-31.	-8.	-79.	-9.	-3.	0.
ARK...	-12.	-21.	-6.	-115.	-8.	-7.	-26.
CAL...	-6.	-23.	-3.	-69.	-7.	-19.	-23.
COL...	-6.	-18.	-8.	-79.	-8.	-6.	-12.
CONN..	-4.	-18.	-4.	-151.	-6.	-11	-18.
DEL...	-7.	-21.	-7.	-128.	-7.	-10.	-12.
D.C...	-14.	-187.	-22.	-308.	-31.	-30.	-41.
FLA...	-10.	-19.	-5.	-76.	-7.	-5.	-8.
GA....	-11.	-20.	-7.	-125.	-7.	-6.	-20.
HA....	-14	-25.	-9.	-110.	-5.	-19.	-17.
IDA...	-6.	-29.	-9.	-62.	-8.	-7.	-14.
ILL...	-8.	-16.	-5.	-130.	-7.	-12.	-18.
IND...	-5.	-22.	-4.	-75.	-7.	-6.	-13.
IOWA..	-4.	-11.	-7.	-44.	-11.	-10.	-15.
KAN...	-3.	-11.	-8.	-75.	-9.	-7.	-15.
KY....	-13.	-25.	-7.	-123.	-8.	-10.	-20.
LA....	-14.	-18.	-6.	-122.	-9.	-9.	-24.
MAINE.	-11.	-23.	-7.	-134.	-14.	-14.	-32.
MD....	-7.	-21.	-11.	-125.	-7.	-10.	-15.
MASS..	-8.	-24.	-4.	-169.	-13.	-17.	-31.
MI....	-6.	-21.	-4.	-78.	-7.	-20.	-22.
MINN..	-4.	-15.	-7.	-116.	-10.	-11.	-27.
MISS..	-15.	-26.	-5.	-100.	-13.	-7.	-25.
MO....	-6.	-18.	-6.	-108.	-7.	-8.	-13.
MONT..	-5.	-37.	-16.	-142.	-9.	-6.	-18.
NEB...	-3.	-13.	-6.	-89.	-9.	-6.	-14.
NEV...	-5.	-27.	-14.	-158.	-4.	-4.	-11.
N.H...	-6.	-13.	-6.	-151.	-12.	-7.	-18.
N.J...	-7.	-23.	-3.	-150.	-6.	-14.	-17.
N.M...	-14.	-32.	-10.	-136.	-12.	-9.	-14.
N.Y...	-9.	-24.	-4.	-186.	-13.	-21.	-40.
N.C...	-9.	-18.	-5.	-118.	-9.	-7.	-16.
N.D...	-3.	-19.	-13.	-132.	-13.	-5.	-15.
OHIO..	-8.	-18.	-4.	-93.	-7.	-10.	-14.

Major Program Spending
Per Capita Amounts
(continued)

OKLA..	-6.	-22.	-5.	-161.	-9.	-8.	-23.
ORE...	-7.	-26.	-9.	-61.	-11.	-14.	-16.
PA....	-7.	-19.	-4.	-116.	-9.	-15.	-21.
R.I...	-7.	-22.	-4.	-230.	-13.	-15.	-30.
S.C...	-12.	-18.	-4.	-87.	-9.	-6.	-19.
S.D...	-5.	-24.	-11.	-213.	-16.	-8.	-19.
TENN..	-13.	-18.	-6.	-118.	-9.	-6.	-20.
TEX...	-8.	-15.	-5.	-79.	-7.	-3.	-17.
UTAH..	-3.	-26.	-10.	-40.	-9.	-9.	-17.
VER...	-8.	-23.	-11.	-147.	-19.	-16.	-30.
VA....	-6.	-16.	-7.	-93.	-7.	-7.	-14.
WASH..	-6.	-26.	-12.	-77.	-9.	-12.	-17.
W.VA..	-12.	-25.	-14.	-101.	-7.	-9.	-14.
WIS...	-3.	-15.	-5.	-75.	-9.	-14.	-20.
WY....	-3.	-16.	-21.	-77.	-6.	-4.	-6.
N.ENG.	-7.	-22.	-5.	-164.	-12.	-14.	-27.
M.A...	-8.	-22.	-4.	-156.	-10.	-18.	-29.
E.N.C.	-7.	-18.	-4.	-96.	-7.	-13.	-18.
W.N.C.	-4.	-15.	-7.	-98.	-10.	-8.	-17.
S.A...	-9.	-19.	-7.	-102.	-7.	-7.	-14.
E.S.C.	-14.	-22.	-6.	-123.	-10.	-7.	-21.
W.S.C.	-9.	-17.	-5.	-101.	-8.	-5.	-20.
MOUNT.	-7.	-26.	-10.	-89.	-9.	-6.	-10.
PAC...	-6.	-24.	-6.	-71.	-8.	-18.	-21.
N.E...	-8.	-22.	-4.	-158.	-11.	-17.	-29.
N.CT..	-6.	-17.	-5.	-96.	-8.	-12.	-18.
SOUTH.	-10.	-19.	-6.	-106.	-8.	-6.	-17.
WEST..	-6.	-23.	-7.	-76.	-8.	-13.	-18.
NAT.65	-8.	-21.	-6.	-111.	-9.	-12.	-20.

ANALYSIS OF PRESIDENT REAGAN'S FY 1982-83 BUDGET AND ITS IMPACT ON MICHIGAN

SENATE
FISCAL
AGENCY

THEODORE A. FERRIS, DIRECTOR

SENATE FISCAL AGENCY
MICHIGAN LEGISLATURE
LANSING, MICHIGAN

FEBRUARY 24, 1982

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INTRODUCTION

President Reagan's proposed budget for fiscal year 1982-83 portends continued significant financial difficulties for Michigan state and local governments, and Michigan residents who receive federal assistance. This report is intended to present a preliminary analysis of the President's proposed budget and its impact on Michigan. Selected budget issues of particular concern to state government, to units of local government, and to Michigan residents, are analyzed with a focus on a four year financial overview of each program, a brief description of the purpose and current programmatic aspects of each, and a fiscal analysis of the likely implications of the President's proposals on Michigan. The program areas and issues selected represent the major federal programs that account for the greatest share of federal aid to Michigan. In total, 32 individual programs are reviewed in this analysis. In addition, special attention is given to the President's overall budgetary policy, his "New Federalism" proposal, and proposals for block grants.

The reason for this special attention to the federal budget is simple. In FY 1977-80, over $16.1 billion in federal funds were received by Michigan citizens and units of local government, including $4.1 billion in grant funds. Federal revenue to the budget of the State of Michigan over the last decade has consistently accounted for 25% of total receipts. In FY 1980, federal aid to state government alone was in excess of $2.5 billion.

Despite the length and detail of the President's budget documents, important aspects of his proposal are not spelled out and are not available. In some cases, the President has yet to formally present his specific proposals to Congress. His "new federalism" proposal is a case in point. It is likely that revisions to individual sections will be made as additional information becomes available. Estimates of budget authority and outlays for national levels and Michigan's share were derived from detail in the President's "Budget Appendix", internal records of the Senate Fiscal Agency, and the "Geographical Distribution of Federal Funds" (GDFF).

At the end of each program analysis, the name and telephone number of the person responsible for its preparation is listed. Comments and questions concerning any aspect of this document are encouraged.

FEDERAL BUDGET PRIORITIES

OVERVIEW

Under President Ronald Reagan's plan for the future, the priorities of the federal government, as reflected in his FY 1983 budget, are projected to dramatically change between FY 1981 and FY 1985. President Reagan proposes to increase defense spending by $155.6 billion (+85.3%). Total budget outlays, on the other hand, would grow by $225.1 billion (+32.2%) while grants-in-aid to state and local governments would actually fall by $11.2 billion (-11.9%) during that same time period. Tables 1 and 2 summarize proposed changes in federal spending between FY 1981 to FY 1983, and FY 1981 to FY 1985, while Figures 1 - 3 graphically chart annual changes in defense spending, social security outlays, and grants-in-aid, as compared to annual changes in total outlays between FY 1977 and FY 1985.

Perhaps the most striking figure, and probably of greatest concern to many Americans, is that of the national debt (see Table 2). As President Reagan's budget states, the national debt would rise from a FY 1981 level of $1.0 trillion to $1.48 trillion by FY 1985, an increase of 48% in just 4 years. As a direct result, interest outlays to finance that debt would climb by $37.2 billion from $82.5 billion to $119.7 billion (+45.1%). By FY 1985 interest payments alone would surpass the level of total budget outlays that were incurred in FY 1964. As discussed in a following section, President Reagan's recommendations to increase defense spending and incur annual budget deficits in the $70 - $90 billion range could have highly negative effects on the national economic recovery and the general price level.

A principal reason for the size of the annual deficits, in addition to the projected increases in defense spending and a general unwillingness to reduce entitlements, can be traced to the "Economic Recovery Act of 1981." Over the next 5 years, last year's tax package will reduce the annual increases in federal government tax collections by approximately $749 billion. In FY 1982, the President's budget projects that American businesses and taxpayers will receive a $38.3 billion reduction in their overall tax burden. By comparison, the annual effect of the tax cut has been placed at $91.6 billion in FY 1983, $139.0 billion in FY 1984, and $176.7 billion in FY 1985. In FY 1983, Michigan taxpayers stand to "save" over $ 4 billion in federal taxes. Unfortunately for most wage earners their personal income tax cut will be offset by scheduled increases in social security taxes.

GRANTS-IN-AID TO STATE & LOCAL GOVERNMENTS

In the opinion of President Reagan, "in the last 2 decades, the federal government's role in domestic programs has become excessive." The President's FY 1983 budget contains recommendations which would permanently change the scope and level of federal assistance to state and local governments.

Total federal grants-in-aid in FY 1983 would continue the downward direction established in 1982, falling to $81.4 billion from a historic high of $94.8 billion (see Table 3). In FY 1981, federal grants to state and local governments represented 19.5% of domestic budget outlays and 14.4% of total budget outlays. Under President Reagan's plan, grants-in-aid outlays, as a percent of domestic spending, would drop to 15.5%. As a percent of total budget outlays, federal assistance to state and local governments would represent 10.7% if his proposal is adopted. By FY 1985 federal outlays to state and local governments would decrease to a level of $83.5 billion, representing a cumulative reduction in grants-in-aid of $41.3 billion.

FEDERAL AID TO MICHIGAN IN FY 1983

If President Reagan's FY 1983 budget is entirely accepted, Michigan residents could stand to lose in excess of $788 million. State government alone would experience a net decrease in federal revenue of about $426 million while higher education and local school districts would experience a $ 187 million reduction. Table 4 provides a detailed summary of estimated federal outlays to Michigan by individual program between FY 1981 and FY 1983. As it shows, federal aid to Michigan decreased by $ 776 million between FY 1981 and FY 1982 with the passage of the "Omnibus Reconciliation Act of 1981". Added together with the estimated loss in FY 1983, Michigan could experience a $1.56 billion reduction in federal aid during President Reagan's first 2 years in office. The individual program analyses in Section B further identify and outline the programmatic implications to Michigan.

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TABLE 1

TOTAL BUDGET OUTLAYS, BY FUNCTION
FY 1981 TO FY 1983
(dollars in millions)

FEDERAL FUNCTION	FY 1980-81 ACTUAL	FY 1981-82 ESTIMATED	FY 1982-83 RECOMMENDED	CHANGE: FY 1982 TO 1983	
				DOLLAR	PERCENT
National Defense (050)........	$ 159,765	$ 187,497	$ 221,068	$ 33,571	17.9%
International Affairs (150)...	11,130	11,074	11,968	894	8.1
General Science, Space & Technology (250)............	6,359	6,942	7,633	691	10.0
Energy (270).................	10,277	6,413	4,215	(2,198)	(34.3)
Natural Resources & Environment (300)...........	13,525	12,626	9,911	(2,715)	(21.5)
Agriculture (350)............	5,572	8,633	4,494	(4,139)	(47.9)
Commerce & Housing Credit (370).......................	3,946	3,265	1,591	(1,674)	(51.3)
Transportation (400)..........	23,381	21,228	19,628	(1,600)	(7.5)
Community & Regional Development (450)...........	9,394	8,366	7,263	(1,103)	(13.2)
Education, Training, Employment & Social Services (500).......................	31,402	27,770	21,552	(6,218)	(22.4)
Health (550).............. ...	65,982	73,437	78,105	4,668	6.4
Income Security (600).........	225,099	250,870	261,736	10,866	4.3
Veterans Benefits & Services (700).......................	22,988	24,155	24,383	228	.9
Administration of Justice (750)........................	4,698	4,521	4,592	71	1.6
General Government (800)......	4,614	5,146	5,008	(138)	(2.7)
General Purpose Fiscal Assistance (850)...........	6,856	6,417	6,686	269	4.2
Interest (900)...............	82,537	99,095	112,536	13,441	13.6
Allowances...................	0	(624)	(1,257)	(633)	101.4
Undistributed Offsetting Receipts....................	(30,320)	(31,502)	(43,474)	(11,972)	38.0
TOTAL........................	$ 657,205	$ 725,329	$ 757,638	$ 32,309	4.5%

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TABLE 2

CHANGES IN FEDERAL BUDGETARY POLICY
AS PROPOSED BY PRESIDENT REAGAN'S FY 1983 BUDGET
FY 1981 TO FY 1985

(dollars in millions)

FEDERAL FUNCTION	FY 1980-81 ACTUAL	FY 1984-85 RECOMMENDED	CHANGE: FY 1981 TO 1985 DOLLAR	PERCENT
National Defense (050)............	$ 182,405	$ 338,011	$155,606	85.3%
International Affairs (150).......	24,812	16,410	(8,402)	(33.9)
General Science, Space & Technology (250).................	6,533	7,270	737	11.3
Energy (270)......................	6,769	4,102	(2,667)	(39.4)
Natural Resources & Environment (300)...........................	11,128	7,313	(3,815)	(34.3)
Agriculture (350).................	6,646	4,482	(2,164)	(32.6)
Commerce & Housing Credit (370)...	6,537	4,571	(1,966)	(30.1)
Transportation (400)..............	24,920	19,468	(5,452)	(21.9)
Community & Regional Development (450)...........................	8,143	6,978	(1,165)	(14.3)
Education, Training, Employment & Social Services (500)............	30,550	17,762	(12,788)	(41.9)
Health (550)......................	68,936	93,593	24,657	35.8
Income Security (600).............	249,918	310,170	60,252	24.1
Veterans Benefits & Services (700)	23,167	27,048	3,881	16.8
Administration of Justice (750)...	4,343	4,530	187	4.3
General Government (800)..........	5,125	5,210	85	1.7
General Purpose Fiscal Assistance (850)...........................	6,251	7,245	994	15.9
Interest (900)....................	82,537	119,726	37,189	45.1
Allowances........................	0	0	0	.0
Undistributed Offsetting Receipts.	(30,320)	(4,386)	25,934	(85.5)
TOTAL.............................	$ 718,400	$ 989,503	$271,103	37.7%

ADDENDUM:

Grants-In-Aid to State & Local Governments.....................	$ 94,762	$ 83,517	$(11,245)	(11.9)%
Medicare Outlays..................	39,149	63,010	23,861	60.9
Social Security...................	137,970	202,251	64,281	46.6
TOTAL NATIONAL DEBT...............	$ 1,003,900	$ 1,486,100	$482,200	48.0%

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TABLE 3

TOTAL NATIONAL OUTLAYS FOR GRANTS-IN-AID TO STATE AND LOCAL GOVERNMENT (FY 1976 to FY 1985)

(Dollars in Millions)

Fiscal Year	Grants-In-Aid (In Billions)	Increase/(Decrease) Over Prior Year	
		Dollar	Percent
1976	$59,093	$ 9,259	18.6%
1977	68,414	9,321	15.8
1978	77,889	9,475	13.8
1979	82,858	4,969	6.4
1980	91,472	8,614	10.4
1981	94,762	3,290	3.6
1982*	91,220	(3,542)	(3.7)
1983*	81,418	(9,802)	(10.7)
1984*	81,853	435	.5
1985*	83,517	(1,664)	2.0

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* As recommended, FY 1982-83 Executive Budget.

Source: Special Analysis H, "Federal Aid to State and Local Governments", Office of Management and Budget, Executive Office of the President, February 1982.

TABLE 4

CHANGES IN FEDERAL ASSISTANCE TO MICHIGAN
AS PROPOSED IN PRESIDENT REAGAN'S FY 1983 BUDGET
FY 1981 TO FY 1983
(dollars in thousands)

FEDERAL FUNCTION/PROGRAM	FY 1980-81 ESTIMATED	FY 1981-82 ESTIMATED	FY 1982-83 RECOMMENDED	DOLLAR CHANGE:		TOTAL CHANGE:
				FY 1981-1982	FY 1982-1983	FY 1981 TO FY 1983
NATIONAL DEFENSE (050)						
DOD-ARMY, National Guard centers construction.........	1,197	1,197	1,357	0	160	160
Total National Defense........	1,197	1,197	1,357	0	160	160
NATURAL RESOURCES & ENVIRONMENT (300)						
DAG-ASCS, Agricultural conservation program.........	4,394	4,944	1,294	550	(3,650)	(3,100)
DOC-NOAA, Operations, research & facilities grants.	1,094	604	89	(490)	(515)	(1,005)
DOI, Urban park & recreation fund.........................	3,439	420	0	(3,019)	(420)	(3,439)
DOI, Land & water conservation fund............	5,765	718	0	(5,047)	(718)	(5,765)
DOI, Historic preservation fund.........................	557	410	0	(147)	(410)	(557)
EPA, Abatement, control & compliancee..................	13,167	10,876	8,269	(2,291)	(2,607)	(4,898)
EPA, Construction grants for treatment plants.............	220,063	229,635	168,683	9,572	(60,952)	(51,380)
EPA, Research & development contracts & grants...........	3,346	3,548	2,934	202	(614)	(412)
Subtotal Natural Resources & Environment..................	251,825	251,155	181,269	(670)	(69,886)	(70,556)
AGRICULTURE (350)						
DAG, Extension service activities....................	5,949	6,158	6,053	209	(105)	104
Total Agriculture.............	5,949	6,158	6,053	209	(105)	104
TRANSPORTATION (400)						
DOT-FAA, Grants in aid for airports.....................	12,700	13,600	13,600	900	0	900
DOT-FHA, Federal aid to highways.....................	223,615	203,204	193,084	(20,411)	(10,120)	(30,531)
DOT-FHA, Highway-related safety grants.................	1,125	402	0	(723)	(402)	(1,125)
DOT-NHTSA, State and community highway safety grants	6,934	3,993	2,978	(2,941)	(1,015)	(3,956)

TABLE 4 (CONTINUED)

FEDERAL FUNCTION/PROGRAM	FY 1980-81 ESTIMATED	FY 1981-82 ESTIMATED	FY 1982-83 RECOMMENDED	DOLLAR CHANGE:		TOTAL CHANGE:
				FY 1981-1982	FY 1982-1983	FY 1981 TO FY 1983
DOT-UMTA, Mass transit assistance....................	95,331	82,446	70,891	(12,885)	(11,555)	(24,440)
Total Transportation..........	319,705	303,645	280,553	(36,060)	(23,092)	(59,152)
COMMUNITY & REGIONAL DEVELOPMENT (450)						
DAG-FMHA, Rural industrial development grants...........	107	0	0	(107)	0	(107)
DAG-FHMA, Rural water & waste disposal grants........	5,860	3,547	3,348	(2,313)	(199)	(2,512)
DOC-EDA, Economic development assistance programs......................	12,536	5,900	0	(6,636)	(5,900)	(12,536)
HUD-CPD, Community development block grants.....	157,636	144,900	144,900	(12,736)	0	(12,736)
HUD-CPD, Urban development action grants................	56,295	36,706	36,696	(19,589)	(10)	(19,599)
Total Community & Regional Development..................	232,434	191,053	184,944	(41,381)	(6,109)	(47,490)
EDUCATION, TRAINING, EMPLOYMENT & SOCIAL SERVICES (500)						
Education:						
DED, Bilingual education....	3,346	3,548	2,934	202	(614)	(412)
DED, Education of the handicapped block grant......	33,131	33,794	27,373	663	(6,421)	(5,758)
DED, Guaranteed student loans........................	287,800	200,000	117,000	(87,800)	(83,000)	(170,800)
DED, Impact aid.............	6,710	3,743	2,358	(2,967)	(1,385)	(4,352)
DED, Pell grants............	89,200	86,600	54,700	(2,600)	(31,900)	(34,500)
DED, State education block grant........................	151,400	128,816	87,480	(22,584)	(41,336)	(63,920)
DED, State student incentive grants.......................	3,183	3,055	0	(128)	(3,055)	(3,183)
DED, Supplemental educational opportunity grants.......................	13,317	10,078	0	(3,239)	(10,078)	(13,317)
DED, Vocational & adult education block grant........	29,039	27,591	17,895	(1,448)	(9,696)	(11,144)
Total Education:	617,126	497,225	309,740	(119,901)	(187,485)	(307,386)

TABLE 4 (CONTINUED)

FEDERAL FUNCTION/PROGRAM	FY 1980-81 ESTIMATED	FY 1981-82 ESTIMATED	FY 1982-83 RECOMMENDED	DOLLAR CHANGE: FY 1981-1982	DOLLAR CHANGE: FY 1982-1983	TOTAL CHANGE: FY 1981 TO FY 1983
Employment & Training:						
DOL, Employment & training block grant..................	227,400	125,300	58,700	(102,100)	(66,600)	(168,700)
DOL-ETA, Employment services	29,693	18,348	15,523	(11,345)	(2,825)	(14,170)
DOL-ETA, Grants to states for unemployment insurance services......................	152,702	141,336	151,025	(11,366)	9,689	(1,677)
Total Employment & Training...	409,795	284,984	225,248	(124,811)	(59,736)	(184,547)
Social Services:						
ACT, VISTA..................	665	211	0	(454)	(211)	(665)
HHS, Community services block grant..................	17,737	13,299	3,911	(4,438)	(9,388)	(13,826)
HHS, Social services block grant........................	121,400	97,400	80,100	(24,000)	(17,300)	(41,300)
HHS, Programs for the aging.	29,040	28,540	22,330	(500)	(6,210)	(6,710)
HHS, Head start program.....	0	28,540	0	28,540	(28,540)	0
HHS, Developmental disabilities,................	1,671	1,730	1,081	59	(649)	(590)
Total Social Services.........	170,513	169,720	107,422	(793)	(62,298)	(63,091)
HEALTH (550)						
HHS, Alcohol, drug abuse & mental health block grant....	18,800	13,236	13,236	(5,564)	0	(5,564)
HHS, Maternal & child health service block grant..........	45,500	47,900	37,400	2,400	(10,500)	(8,100)
HHS, Preventive health & health services block grant..	4,400	3,400	3,400	(1,000)	0	(1,000)
HHS, Primary care block grant........................	17,600	12,600	12,700	(5,000)	100	(4,900)
HHS-HCFA, Medicaid..........	703,600	780,900	731,200	77,300	(49,700)	27,600
HHS-HCFA, Program management	2,115	1,140	530	(975)	(610)	(1,585)
HHS-HRA, Health resources grants......................	13,843	8,681	3,722	(5,162)	(4,959)	(10,121)
Total Health..................	805,858	867,857	802,188	61,999	(65,669)	(3,670)
INCOME SECURITY (600)						
DAG-FNS, Child nutrition programs.....................	86,251	75,010	74,371	(11,241)	(639)	(11,880)
DAG-FNS, Food stamp program.	412,200	425,000	279,300	12,800	(145,700)	(132,900)
DAG-FMHA, Very low income housing repair grants........	553	365	304	(188)	(61)	(249)
DOC-EDA, Trade adjustment assistance..................	554,400	40,000	0	(514,400)	(40,000)	(554,400)
HHS, Assistance payments programs.....................	584,900	561,000	459,000	(23,900)	(102,000)	(125,900)

TABLE 4 (CONTINUED)

FEDERAL FUNCTION/PROGRAM	FY 1980-81 ESTIMATED	FY 1981-82 ESTIMATED	FY 1982-83 RECOMMENDED	DOLLAR CHANGE: FY 1981-1982	DOLLAR CHANGE: FY 1982-1983	TOTAL CHANGE: FY 1981 TO FY 1983
HHS, Home energy assistance block grant..................	110,800	108,600	73,300	(2,200)	(35,300)	(37,500)
HHS, Supplementary security income program..............	172,200	187,200	208,400	15,000	21,200	36,200
HHS-SSA, Child support enforcement..................	23,437	34,500	29,344	11,063	(5,156)	5,907
Total Income Security.........	1,944,741	1,431,675	1,124,019	(513,066)	(307,656)	(820,722)
ADMINISTRATION OF JUSTICE (750)						
DOJ, Law enforcement assistance....................	8,500	6,490	0	(2,010)	(6,490)	(8,500)
Total Administration of Justice......................	8,500	6,490	0	(2,010)	(6,490)	(8,500)
TOTAL GRANTS-IN-AID...........	4,787,643	4,011,159	3,222,793	(776,484)	(788,366)	(1,564,850)

FIGURE 1

ANNUAL PERCENTAGE CHANGE IN TOTAL BUDGET OUTLAYS AND DEFENSE OUTLAYS

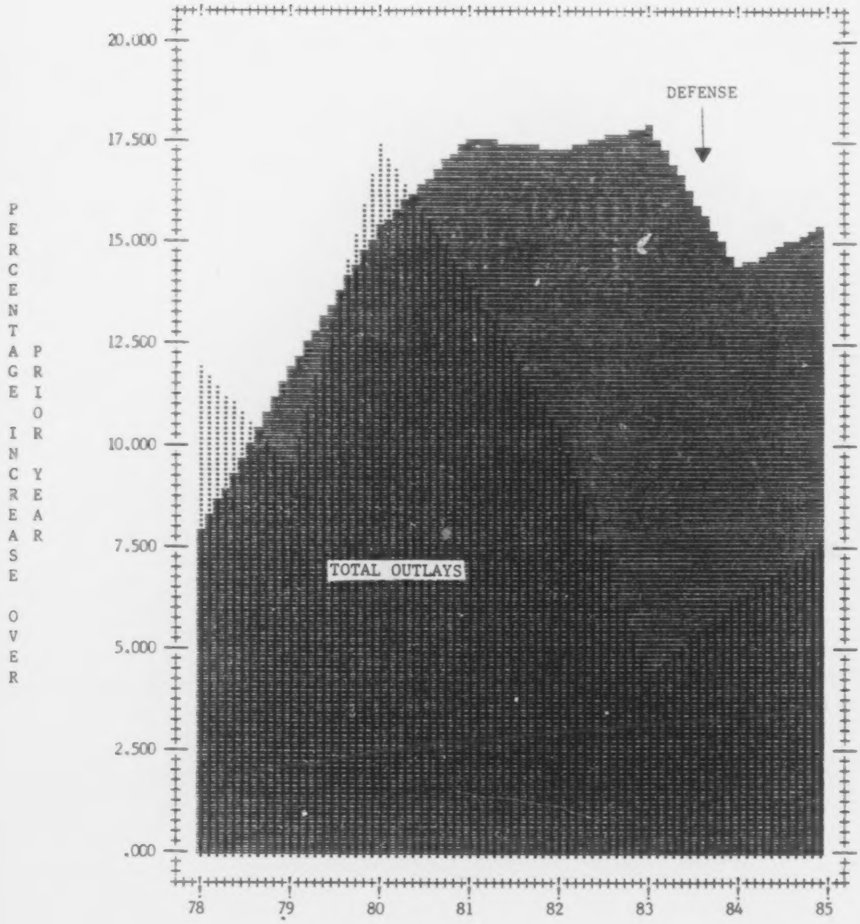


FIGURE 2

ANNUAL PERCENTAGE CHANGE IN TOTAL BUDGET OUTLAYS AND

SOCIAL SECURITY OUTLAYS

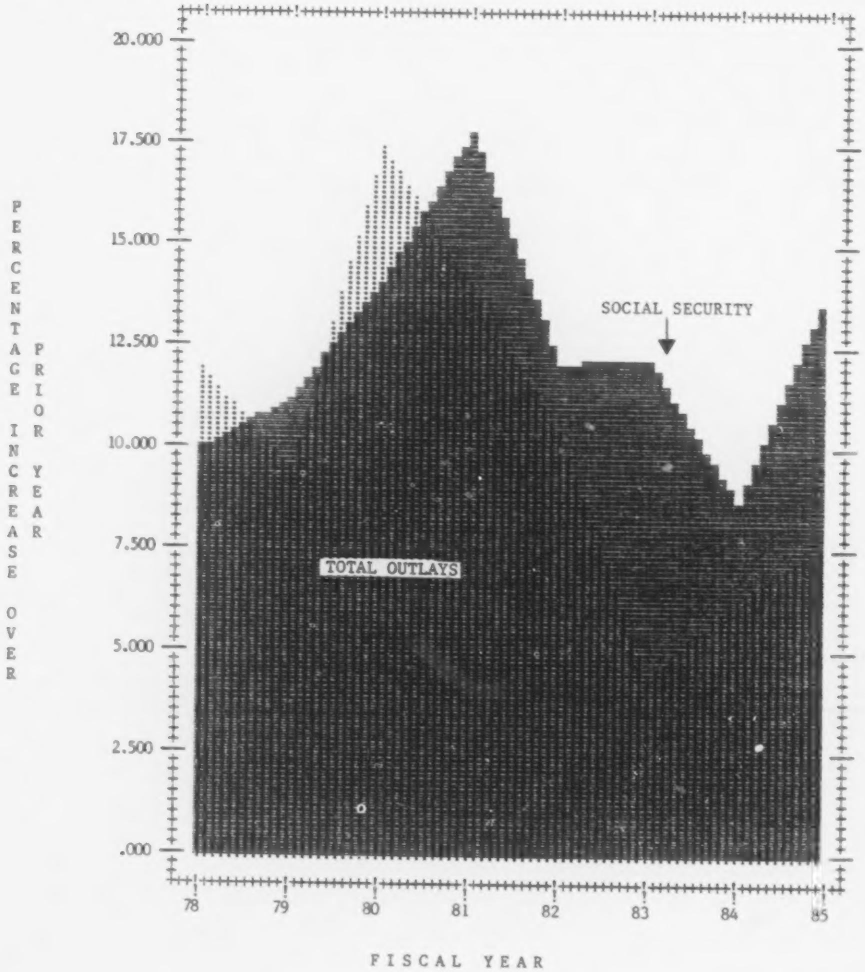
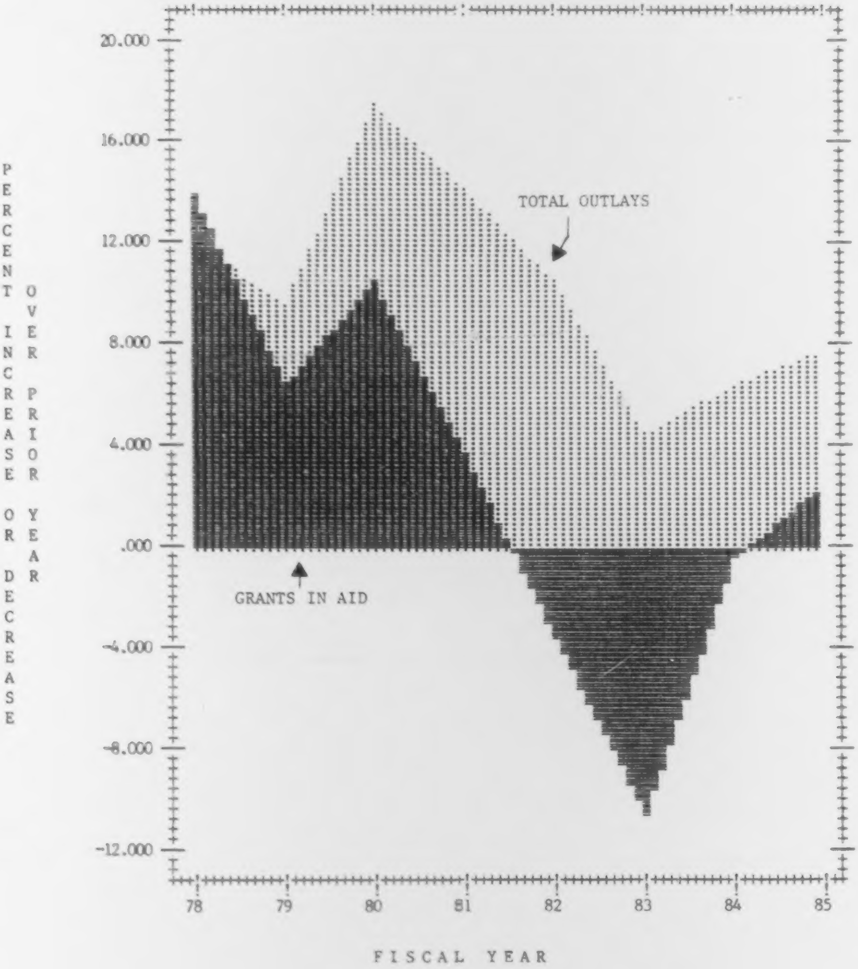


FIGURE 3

ANNUAL PERCENTAGE CHANGE IN TOTAL OUTLAYS AND GRANTS-IN-AID TO STATE AND LOCAL GOVERNMENTS



ECONOMIC ASSUMPTIONS AND THE FEDERAL BUDGET

President Reagan's Fiscal Year 1983 Federal Budget proposal is developed amidst an economic forecast prepared by his economic advisors. The validity of their economic forecast is critical in determining whether the revenue and expenditure figures contained in the budget message are accurate. Changes in the economic assumptions will have a major impact on many parts of the budget.

Table 1 presents the basic economic forecast that was used in preparing the budget. The table shows that the Administration is expecting little or no real growth in the national economy, as measured by real Gross National Product (GNP), in 1982. Substantial real growth is projected to take place in 1983 and thereafter. Inflation, as measured by the Consumer Price Index (CPI), is expected to continue the moderation that began in the middle of 1981 through both 1982 and 1983. The national unemployment rate is expected to decline slightly in 1983 after averaging almost 9.0% throughout 1982. The forecast for interest rates is that there will be some moderation from the high levels of 1981 in both 1982 and 1983. However, these historically high projected interest rates on 91 day treasury bills may be even higher if action is not taken to reduce the federal deficit.

Table 2 compares the major components of the Administration's economic forecast for 1982 and 1983, which are quite consistent with both the Research Seminar in Quantitative Economics (RSQE), the Congressional Budget Office (CBO), and the Chase Econometrics forecasts. For the important indicator, real GNP, the Administration's forecast is slightly more optomistic for 1982, but in between the other forecasts for 1983.

Perhaps the major point of difference between economic forecasters concerning the federal budget is the projected size of the deficit. Table 3 presents the Administration's and the CBO's forecasts of the size of the federal budget deficit for fiscal years 1983 and 1984. The difference in opinion, as to the size of the deficit, is major.

The size of the federal budget deficit has been growing steadily in the past 20 years. In 1965, the deficit was $1.6 billion or 0.2% of GNP. According to CBO estimates, the 1984 deficit would be $188 billion or 5.0% of GNP. Table 4 and Figure 1 give the details on the budget deficit over the past 20 years.

The size of the federal budget deficit has two major negative effects on the economy. The economic variables affected are inflation and interest rates. If the Federal Reserve Board decides to help the U.S. Treasury finance the deficit by increasing the nation's money supply (printing dollars) we can expect upward pressure on inflation. If the federal government finances the deficit by borrowing money we can expect upward pressure on interest rates. In reality, a combination of increasing the money supply and borrowing is used to finance the deficit. The Administration's current policy is to primarily finance the deficit by borrowing. If this policy continues, we can expect little or no moderation in interest rates until the size of the deficit is reduced.

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TABLE 1

ADMINISTRATION ECONOMIC FORECAST
(calendar year; billions of dollars)

ITEM	CY 1980[1]	CY 1981[1]	CY 1982[2]	CY 1983[2]
GROSS NATIONAL PRODUCT:				
Current Dollars:				
Amount	$2,626	$2,922	$3,160	$3,524
% Change Over Prior Year	8.8%	11.3%	8.1%	11.5%
Constant (1972) Dollars:				
Amount	$1,481	$1,510	$1,513	$1,591
% Change Over Prior Year	(0.2)%	2.0%	0.2%	5.2%
INCOMES:				
Personal Income	$2,160	$2,404	$2,641	$2,887
Wages & Salaries	$1,344	$1,483	$1,605	$1,747
Corporate Profits	246	230	215	260
PRICE LEVELS:				
GNP Deflator:				
Level 1972=100.0 (annual average)	177.4	193.6	208.9	221.5
% Change Over Prior Year	9.0%	9.1%	7.9%	6.0%
CPI:				
Level 1967=100.0 (annual average)	247.0	272.3	292.1	309.5
% Change Over Prior Year	13.5%	10.3%	7.3%	6.0%
UNEMPLOYMENT RATES:				
Total: Annual Average	7.1	7.6	8.9	7.9
INTEREST RATES:				
91 Day Treasury Bills	11.5	14.1	11.7	10.5

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[1] Actual
[2] Forecast

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TABLE 2

ECONOMIC FORECASTS
ADMINISTRATION, R.S.Q.E., CHASE, AND C.B.O.

	ADMINISTRATION	R.S.Q.E.	CHASE	C.B.O.
% CHANGE IN REAL GNP				
Calender 1982	0.2%	0.0%	(0.3)%	(0.1)%
Calender 1983	5.2%	5.8%	4.0%	4.4%
% CHANGE IN PERSONAL INCOME				
Calender 1982	9.9%	9.2%	8.8%	N/A
Calender 1983	9.3%	11.1%	10.9%	N/A
% CHANGE IN CPI				
Calender 1982	7.3%	7.4%	8.0%	7.5%
Calender 1983	6.0%	7.1%	7.9%	6.9%
UNEMPLOYMENT RATE				
Calender 1982	8.9%	9.3%	9.1%	8.9%
Calender 1983	7.9%	7.8%	8.1%	8.0%
TREASURY BILL RATE (90 DAYS)				
Calender 1982	11.7%	12.2%	12.1%	12.0%
Calender 1983	10.5%	11.5%	11.6%	13.2%

TABLE 3

PROJECTED FEDERAL BUDGET DEFICIT

FORECASTER	FISCAL YEAR 1983	FISCAL YEAR 1984
ADMINISTRATION	$ 91.5	$ 82.9
CONGRESSIONAL BUDGET OFFICE	$157.0	$188.0

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TABLE 4

FEDERAL BUDGET SURPLUS/(DEFICIT) VERSUS GROSS NATIONAL PRODUCT

(in billions of dollars)

FISCAL YEAR	(DEFICIT) OR SURPLUS	G.N.P.	(DEFICIT) OR SURPLUS AS PCT. OF G.N.P.
1965	$ (1.6)	$ 638.1	0.2%
1966	(3.8)	753.0	0.5
1967	(8.7)	796.3	1.1
1968	(25.2)	868.5	2.9
1969	3.2	935.5	0.4
1970	(2.8)	982.4	0.3
1971	(23.0)	1,063.4	2.2
1972	(23.4)	1,171.1	2.0
1973	(14.8)	1,306.6	1.1
1974	(4.7)	1,412.9	0.3
1975	(45.2)	1,528.8	3.0
1976	(66.4)	1,702.2	3.9
1977	(45.0)	1,899.5	2.4
1978	(48.9)	2,127.6	2.3
1979	(27.8)	2,413.9	1.2
1980	(61.2)	2,626.1	2.3
1981	(61.5)	2,922.0	2.1
1982	(109.0)[1]	3,140.0[2]	3.5
1983	(157.0)[1]	3,515.0[2]	4.5
1984	(188.0)[1]	3,760.0[2]	5.0

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[1] Congressional Budget Office Estimates

[2] Chase Econometrics Estimate

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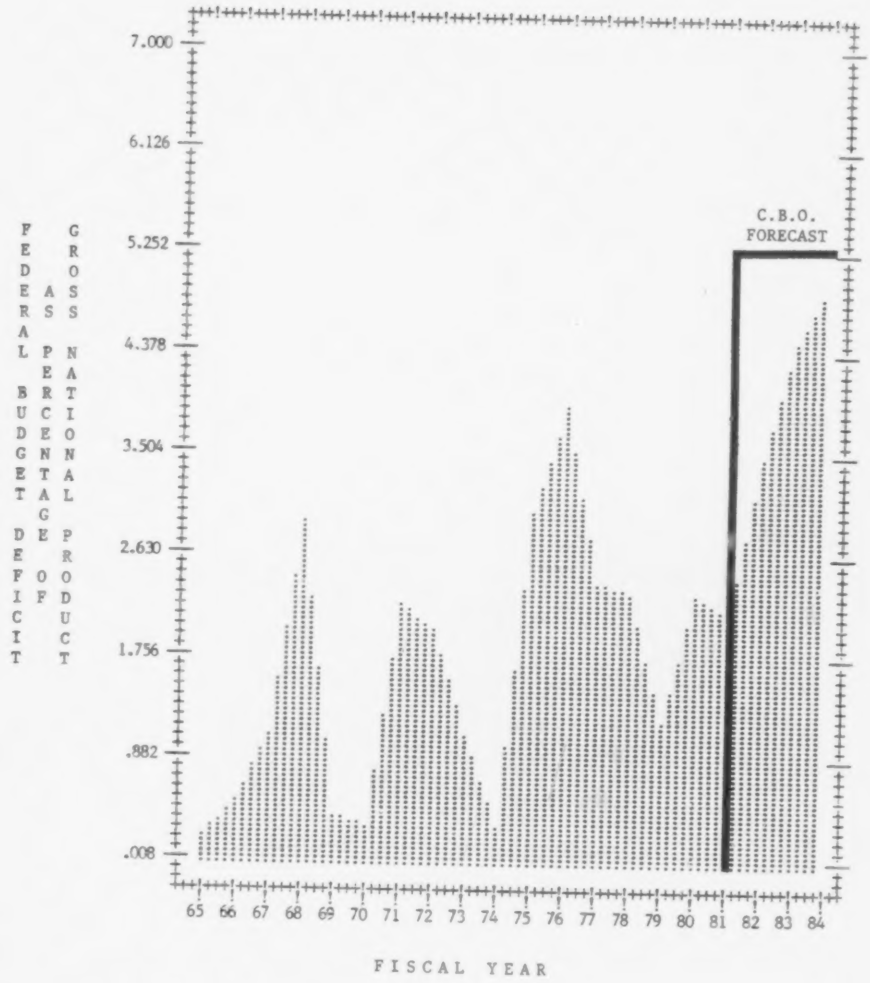
FIGURE 1

FEDERAL BUDGET DEFICIT
AS PERCENTAGE OF
GROSS NATIONAL PRODUCT



ECONOMIC IMPACT OF THE SURGE IN NATIONAL DEFENSE SPENDING

Overview

President Reagan's recommendations for defense spending call for a $132 billion increase in spending between FY 1981 and FY 1985, for an average annual increase of 16.3%. Defense outlays in FY 1985 would be $292 billion, which approximates total federal outlays for all programs for the budget of 10 years earlier. On the other hand, defense outlays would represent just 7% of Gross National Product (GNP) in FY 1985, which compares to 9.6% in 1955, 7.2% in 1965, and 5.5% in 1975, all peacetime years.

Aside from the absolute level of defense spending, the most important economic concern with respect to defense spending is its rate of growth. Initially, a defense buildup leads to an acceleration of economic growth. Shortly thereafter, however, inflation accelerates as well and real (inflation-adjusted) growth rates decline. As described below, the historical record suggests that defense buildups are inflationary.

For Michigan, a renewed and unanticipated surge in the rate of inflation in the mid-1980's could remove any prospects we have of recouping the economic gains we have lost since 1973.

Why Defense Spending is Inflationary

As economist Robert Lekachman has noted, "war and inflation are particularly old friends."[1] This characterization is apt for the President's proposed rearmament program, because the defense buildup is more typical of that which occurs during a war. Lekachman goes on to claim that "of human activities, wars are by far the most wasteful." And, indeed, this is undeniably sad, but true.

Any defense buildup means more and more dollars are diverted from productive purposes (autos, housing, steel, chemicals, electronics, robotics, energy, etc.) and, instead, are diverted to paying soldiers you hope will never work a day (i.e., fight) and for buying equipment you pray will forever lay idle (such as nuclear missiles).

All of the individuals associated with a defense buildup are paid, whether a soldier, a worker on the line at General Dynamics, or a nuclear physicist. These individuals add to the daily demands placed on our economy for goods and services, yet individually and collectively add nary a cent to this nation's productive capabilities.

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[1] Lekachman, Robert. Inflation: The Permanent Problem of Boom and Bust. Vintage Books, N.Y. 1973.

Hence, defense buildups are inflationary. They lead to a demand-pull type of inflation, which can rapidly become institutionalized in the economy.

Previous Defense Buildups

Defense spending grew by an average of 187.5% per year from 1940-44. Prices grew by 5.4% per year over the period, which although low by today's standards, represented a marked acceleration from the falling prices of the 1930's. Controls instituted during the war along with rationing kept prices much lower than they otherwise would have been, as evidenced by the explosion in the general price level which occurred in the immediate years after World War II when controls were lifted. From 1946-49 prices rose an average of 12% per year, representing an inflationary burst which is yet to be matched, as measured by the GNP price deflator.

The next major defense buildup occurred in 1951-52 for the Korean War, when the average increase for the two-year period was 94%. Again, controls were instituted, but the 6.8% increase in prices recorded in 1951 did represent an acceleration from the average 2.6% increase in prices from 1948-50. The rather modest increase in prices resulting from this particular buildup may have been attributable to the fact that even in 1952, at the height of the Korean conflict, defense spending was just one-half of what it was eight years earlier at the most costly point of World War II. In fact, the defense spending level of $87.4 billion for 1944 was not surpassed until 1977.

The defense buildup associated with the Vietnam War was concentrated in the three-year period 1967-69, when spending rose by 16% per year, as compared to an average annual increase of less than 1% for the prior seven years. Prices rose by less than 2% per year in the same seven-year period prior to the escalation for Vietnam, but rose by some 5% per year from 1968-71. In 1971, wage/price controls were once again instituted and, thereafter, removed in 1973 as American involvement in Vietnam was phased-out. As expected, the price pressures associated with the war, in conjunction with the 1973-74 quadrupling of OPEC oil prices, blew the lid off prices in 1974-75 when prices leapfrogged by nearly 10% per year.

Implications for 1982-85 and the State of Michigan

President Reagan is proposing that defense outlays grow by 16.3% per year over the four-year period, 1982-85, marking the sharpest peacetime increase in defense spending in this century. Given the economic proposition that defense spending must be inflationary (in lieu of a concerted policy of the Federal reserve to counter the buildup, which would likely plunge the economy into a deep recession); given the historical record that previous defense buildups have been followed by an accelerating rate of inflation; and given the President's strong opposition to wage/price controls, it would appear improbable that the 1982-85 period will be one of a steady decline in the annual rate of inflation to under 5% as the Administration is assuming, if his 16.3% per year increase in defense spending is approved.

For Michigan, the defense buildup may deal a double-blow to our economy. First, Michigan receives a very small portion of defense outlays as compared to our population and federal taxes paid. We receive only 1 cent of every defense dollar spent whereas, we pay the taxes to support over 4 cents in every dollar spent. Secondly, there is no state in this country more negatively impacted by an unanticipated surge in inflation. Witness 1974-75 and 1980-81 and the devastating impact of these two inflation-induced recessions on Michigan.

The most serious, structural flaw in the Administration's economic game plan for 1982-85 may be the notion that we can have a massive defense buildup without paying the additional costs associated with the resultant inflationary surge.

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"NEW FEDERALISM"

OVERVIEW

In his 1982 State of the Union Address, President Reagan announced a far reaching proposal to dramatically change the fundamental relationshp between the federal government and state and local governments. Referred to as his "New Federalism" proposal, the plan would transfer the responsibility of 44 domestic programs, which are currently financed by the federal government, to the states in return for federal assumption of the costs of the Medicaid program. A trust fund to offset a portion of the federal revenue losses would be established and available to compensate state and local governments. Although his proposal does not yet entirely identify the specific programs which would be transferred or the programmatic details of the shift in responsibilities, several initial observations and conclusions can be offered at this time. Further details on his proposal are expected to be released this spring when the legislation to accomplish his objectives is introduced in Congress.

Effective in FY 1984, the President proposes a "2 for 1 swap" of three social welfare programs. The federal government would assume the full costs of financing the Medicaid program. Currently, Medicaid is administered by the states with the federal government's share of total costs varying between 47%-80%. In FY 1982, the federal government's matching rate for Michigan will likely be about 49%. In return, the states would be assigned full responsibility of the Aid to Families with Dependent Children (AFDC) program and the Food Stamp program. Present Michigan law provides for the state to pay one-half of the costs for the AFDC program, while the federal government underwrites the full cost of the Food Stamp program. Details on minimum eligibility and benefit requirements under the new proposal are currently unspecified. In FY 1982, the federal share of the Medicaid program is budgeted at $17.9 billion while the AFDC and Food Stamp programs cost the federal government $20.1 billion. However, because of projected increases in health costs, Medicaid costs under current policy would climb to $20.9 billion in FY 1984 while combined costs of AFDC and Food Stamps are projected to rise by only $100 million over FY 1982 levels. President Reagan's proposal assumes Congressional action which would reduce FY 1984 Food Stamps and AFDC outlays by $3.6 billion and Medicaid costs by $2.2 billion. The administration indicates that adjustments for any gains or losses that states might suffer under the swap would be provided for in the revenues earmarked to a special "Federalism Trust Fund" (see below).

The second major component of President Reagan's "New Federalism" involves shifting 44 federal programs, covering 125 individual grant programs, from the federal government to the states (see Table 1 for the list of programs identified by O.M.B.). A new $28 billion trust fund "belonging to the states" would be established, funded from existing excise taxes on alcohol, tobacco and telephone services, $.02 of the federal gas tax, and a portion of the windfall profits tax.

Beginning in FY 1984 and continuing through FY 1988, the states would have the option of assuming full control over all of the individual grant programs. Allocations from the trust fund would be based on a state's 1979-1981 share of the total of the individual categorical grants being shifted. States would be required to pass through to local government all federal dollars which formerly went to locals prior to his "New Federalism". Education grants generally would not have to be passed on. Of the remaining amount received by the trust fund, 15% would have to be passed through to locals, using the federal general revenue sharing formula. A second option to the states would be for the federal government to continue to administer the individual grant programs. Grant amounts would be deducted from the state's allocation of the trust fund. Beginning in FY 1988, the federal tax rate applying to trust fund revenues would be reduced by 25%, and each year thereafter. By FY 1991, the trust fund would be depleted and the taxing authority repealed.

ANALYSIS OF IMPACT ON MICHIGAN

Several major questions, concerns, and problems can be immediately identified with President Reagan's "New Federalism" proposal in terms of its impact on Michigan and how it meets generally accepted principles of our federal system.

Over the last twenty years, federal involvement and financial assistance in public assistance and income support has steadily increased as Congress recognized and assumed responsibility for many of the underlying causes of poverty and unemployment. It was obvious the plight of the poor and working poor was a direct result of national policies that contributed to the level of unemployment and the creation of new jobs. Furthermore, because of the difference which existed (and still does) between the states in their financial capacity to deal with the effects of poverty and unemployment the Congress acted to partially address these problems by providing financial assistance to the states. It was believed that a person's residency in a particular state should not dictate the level of public assistance provided. The existence of a progressive income tax at the federal level, coupled with a structural ability to incur deficits in times of economic recession, made the federal government best equipped to assist the states. These points are still valid today.

Table 2 presents an 8 year overview of the probable estimated impact the President's proposal to swap Medicaid and Food Stamp programs would have had on the budget of Michigan if it had been law beginning in FY 1974. In 7 out of the 8 fiscal years, Michigan would have been a net loser, incurring $865.6 million in additional net costs between FY 1974 and FY 1981. During 4 of those 7 years, the state economy was in a recession, thus, causing state revenues to fall short of providing sufficient resources to offset the increased demands on social services. In FY's 1980 and 1981 Michigan's annual additional net costs would have been in excess of $200 million. Since Michigan has a Constitutional requirement of a balanced state budget, the legislature would have been forced to either raise taxes or cut state services. In the last 2 years, this is precisely what has happened as grant levels for both AFDC and GA recipients are now over 10% below their 1980 level, before taking into account increases in consumer prices. Since FY 1980, over $1 billion in cuts have been made to the state budget. Given the pressures facing the Congress to reduce federal spending, it is doubtful that sufficient revenues from the "Federalism Trust Fund" could have been available to offset revenue losses to state government.

An additional financial consideration to Michigan is what would occur as the federal government assumed the costs of Medicaid. Because Michigan has one of the more comprehensive Medicaid systems in the nation, it is probable that funding for "optional services" currently provided to recipients of AFDC and SSI would be terminated by the federal government. If the Congress eventually adopted lower levels of coverage, state governments would be placed in the position of deciding whether or not state resources would be appropriated to supplement the federally paid Medicaid program, a potential additional cost exceeding $200 - 400 million annually to Michigan.

Since the President has released only sketchy details of his proposal to transfer the 50 individual programs, analysis of this portion of his package will be prepared at a later date.

TABLE 1

LIST OF PROGRAMS PROPOSED FOR TURNBACK TO THE STATES UNDER PRESIDENT REAGAN'S "NEW FEDERALISM"

FEDERAL PROGRAM	TYPES OF GRANTS AWARDED IN FY 1981
Vocational Rehabilitation	5
Vocational and Adult Education	13
State Block Grants (ECIA Ch.2)	28
CETA	8
WIN	1
Low Income Home Energy Assistance	1
Child Nutrition	4
Child Welfare	1
Adoption Assistance	1
Foster Care	1
Runaway Youth	1
Child Abuse	1
Social Services Block Grant	3
Legal Services	1
Community Services Block Grant	8
Prevention Block Grant	8
Alcohol, Drug Abuse and Mental Health Block Grant	5
Primary Care Block Grant	1
Maternal and Child Health Block Grant	7
Primary Care Research and Development	1
Black Lung Clinics	1
Migrant Health Clinics	1
Family Planning	1
Women, Infants and Children (WIC)	1
Grants-in-Aid for Airports	2
Highways (Primary, Rural, Urban, Bridge Construction Safety, Highway Safety, Other)	7
Interstate Transfer	1
Appalachian Highways	1
Urban Mass Transit (Construction, Operating)	2
Water and Sewer (Grants, Loans)	2
Community Facilities Loans	1
Community Development Block Grant	2
Urban Development Action Grants	1
Waste Water Treatment Grants	1
OSHA State Grants	1
General Revenue Sharing	1
TOTAL	125

Source: Office of Management and Budget.

NOTE: Because the Office of Management and Budget has not released the detailed list of federal programs and grants included in the President's turnback program, the national funding amounts for each program, as well as Michigan's share, are not currently available.

TABLE 2

IMPACT OF PRESIDENT'S PROPOSED SHIFT IN PUBLIC ASSISTANCE PROGRAMS ON STATE OF MICHIGAN BUDGET IF PROGRAM HAD BEEN IN EFFECT BETWEEN FY 1974 AND FY 1981

(dollars in millions)

FISCAL YEAR ENDING	STATUS OF MICHIGAN ECONOMY	PROGRAM SHIFT PROPOSED			INCREASE/(DECREASE) COSTS TO STATE BUDGET
		TO WASHINGTON:	TO LANSING:		
		MEDICAID	A.F.D.C.	FOOD STAMPS	
June 30, 1974	Expansion	$ (274.1)	$ 278.2	$ 82.4	$ 86.5
June 30, 1975	Recession	(385.0)	331.6	129.3	75.9
June 30, 1976	Recession	(329.7)	310.1	155.7	136.1
Sept. 30, 1977	Expansion	(473.9)	386.8	144.1	57.0
Sept. 30, 1978	Expansion	(522.2)	414.7	132.7	25.2
Sept. 30, 1979	Expansion	(639.0)	454.1	178.9	(6.0)
Sept. 30, 1980	Recession	(621.3)	567.3	272.2	218.2
Sept. 30, 1981	Recession	(703.6)	584.9	412.2	293.5

Source: Community Services Administration annual report entitled "Geographical Distribution of Federal Funds", FY 1974 to FY 1981.

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BLOCK GRANT RECOMMENDATIONS

The "Omnibus Reconciliation Act of 1981", enacted into law last August, established or modified nine new federal block grants, eight of which were effective in FY 1982 and one in FY 1983. President Reagan's budget recommendations contain funding for seven new block grants or consolidated programs in FY 1983.

Briefly stated, the nine block grants authorized in 1981 were:

- "Alcohol, Drug Abuse and Mental Health Block Grant", which consolidated six categorical grant programs for alcohol, drug abuse and community mental health centers;
- "Community Development Support Assistance Block Grant", which combined four categorical grants and the small cities portion of the community development block grant;
- "Community Services Block Grant", which incorporate seven categorical grants previously funded through the now defunct Community Services Administration;
- "Education Block Grant", which merged forty-four previously separate categorical grants for special education needs of disadvantaged children and for elementary and secondary education;
- "Low Income Home Energy Assistance Block Grant", which simply renamed the Low Income Energy Assistance Program;
- "Maternal and Child Health Block Grant", which combined nine individual grants previously funded for various Maternal and Child Health programs and several related areas;
- "Preventive Health and Health Services Block Grant", which incorporated seven categoricals in public health, including "Health Incentive Grants for Comprehensive Public Health";
- "Primary Care Block Grant", which authorized funding beginning in FY 1983 for community health centers and hospital affiliated care centers; and
- "Social Services Block Grant", which consolidated three Title XX categoricals for social services into one block grant.

The seven new block grants proposed in FY 1983 include an:

- "Employment and Training Block Grant" which merges the four remaining grants from the CETA program;
- "Vocational and Adult Education Block Grant", an amalgamation of categoricals for each purpose;

- "Education of the Handicapped Block Grant", which combines thirteen separate grants for the handicapped;
- "Rehabilitation Services Block Grant", which would incorporate basic state grants and related project grants;
- "Rental Rehabilitation Block Grant", which would replace the section 8 moderate rehabilitation and the Rehabilitation Loan Fund;
- "Child Welfare Block Grant", which would consolidate all foster care and adoption assistance categorical grants; and
- "Combined Welfare Administration Block Grant", which would merge categorial funding currently for administration of the Medicaid, AFDC and Food Stamp Programs.

The President is also recommending that the Emergency Assistance Program be consolidated with the "Low Income Energy Assistance Block Grant". Also, the Womens, Infants, and Children (WIC) Program would be combined with the "Maternal and Child Health Block Grant".

Specific details, funding changes, and programmatic considerations are outlined in the individual program analyses which follow. In comparing funding levels of these new block grants with the total amounts appropriated to the individual categoricals in prior years, the funding support in all programs are significantly reduced.

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FUNCTION 300

NATURAL RESOURCES & ENVIRONMENT

SENATE FISCAL AGENCY FEDERAL BUDGET ANALYSIS

ENVIRONMENTAL PROTECTION AGENCY
(dollars in millions)

FINANCIAL OVERVIEW

	FY 1980 ACTUAL	FY 1981 ACTUAL	FY 1982 ENACTED*	FY 1983 RECOMMENDATION	CHANGE FY 1982 TO 1983 DOLLAR	CHANGE FY 1982 TO 1983 PERCENT
National Total:	$	$	$	$	$	
Budget Authority	219	297	241	184	57	(23.6)
Budget Outlays	250	300	229	210	19	(8.3)
State of Michigan Est. Allocation	4.5	5.3	5.5	4.5	1.0	(19.0)

PROGRAM DESCRIPTION

The Environmental Protection Agency administers to categorical State grant programs, three of which are a substantial proportion of DNR programs. These grants include air quality, water quality and hazardous wastes. These grants finance a portion of the state's costs of personnel and the expenses for regulation and enforcement under pollution abatement laws. The grants are funded on a formula basis.

PRESIDENT'S RECOMMENDATION

The President has proposed a 19% reduction in EPA's operating budget for FY 1983. The details of the EPA's budget have not been finalized, so the financial impact to Michigan of the 19% cut is not available. But the new "Federalism" philosophy is emerging in the President's recommendations for environmental concerns. The President's budget proposal recommends that the "EPA will initiate actions to increase State flexibility and control over their pollution abatement activities". Translated, this means that the federal government is going to give the states less federal financial support for air quality, water quality and hazardous waste programs.

SFA ANALYSIS OF IMPACT ON STATE OF MICHIGAN

The federal EPA funds the state receives are appropriated to the state's Air Quality, Water Quality and Resource Recovery Programs. The funds assist in financing the enforcement of the state and federal clean air and water acts and hazardous waste act. The programs monitor and test air, water, and solid wastes for pollutants. Over the past few fiscal years the following federal funds were available for the DNR:

	1980	1981	1982	1983
Air	$ 1,950,000	$ 1,950,000	$ 1,950,000	Less than 1982
Water	1,880,000	1,880,000	1,830,000	Less than 1982
Hazardous Waste	700,000	1,450,000	1,700,000	A little more than 1982

Under the President's recommendations, the DNR expects Air and Water grants to decrease while Hazardous Waste grants may increase slightly. If federal funds are decreased significantly, the effects to the state's air and water quality programs would be substantial. Recently the state legislature enacted acts which require a gradual phase out of the industrial surveillance fees and a replacement of the surveillance fees with general fund. The amount of surveillance fee the state can collect is a percentage of the total air and water quality programs. As the federal portion of the total air and water quality programs is reduced, a proportionate amount of surveillance fees will be reduced, thus compounding the reduction. The only alternatives the state would have are to accept the reductions, replace the federal funds with general funds, or amend the current statutes to allow for greater surveillance fee support of the enforcement programs.

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FUNCTION 400

TRANSPORTATION

SENATE FISCAL AGENCY FEDERAL BUDGET ANALYSIS

GRANTS-IN-AID FOR AIRPORTS
(dollars in millions)

FINANCIAL OVERVIEW

	FY 1980 ACTUAL	FY 1981 ACTUAL	FY 1982 ENACTED*	FY 1983 RECOMMENDATION	CHANGE FY 1982 TO 1983 DOLLAR	CHANGE FY 1982 TO 1983 PERCENT
National Total:	$	$	$	$	$	
Budget Authority	677.6	570.5	450.0	450.0	0	0
Budget Outlays	590.3	469.0	-	-	0	0
State of Michigan Est. Allocation	20.5	12.7	13.6	13.6	0	0

PROGRAM DESCRIPTION

- The grants-in-aid for airports program is administered by the Federal Aviation Administration (FAA) under the Department of Transportation (DOT) pursuant to the Airport and Airway Development Act of 1970 (Public Law 91-258, as amended).

- The airport planning and construction program is supported by the federal grants program.

- Federal funding for this program started in 1970 and has continued through 1981. Authority to incur obligations for 1982 and thereafter requires enactment of federal legislation.

- All publicly used airports in this state have received grants under this program.

- Approximately $2 million of state aeronautics fund money (restricted fund) is appropriated annually to support this program.

- The purpose of the program is to plan, develop construct, enlarge, improve, or remodel new or existing airports and facilities located thereon in order to enhance or facilitate commercial and private use of airlines and air travel.

- The program is a matching (federal-state-local) for qualifying projects.

PRESIDENT'S RECOMMENDATION

- A policy change has not been recommended, however, to continue the program beyond 1981 will require federal legislation and there have been statements that the program will remain only for 41 of the major airports. The direction that the program will take at this time is not clear.

- It does not appear that there will be a dollar change in 1983.

- Administrative expenses are not part of this grant program.

- The continuance of this program will not require an increase in the level of state resources.

- The state is not required to assume any new or expanded responsibilities.

SFA ANALYSIS OF IMPACT ON STATE OF MICHIGAN

- As the program appears unchanged, the state remains largely unaffected.

- Options aren't being discussed as the program remains unchanged.

- Federal statute has terminated. New federal legislation is necessary to keep the program going beyond 1981.

- Department resources need not be changed as reductions are not proposed for 1983.

- A new program is not proposed at this time.

- The current level of funding appears to be adequate.

- No other state program is affected by this program.

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SENATE FISCAL AGENCY FEDERAL BUDGET ANALYSIS

MASS TRANSIT ASSISTANCE
(dollars in millions)

FINANCIAL OVERVIEW

	FY 1980 ACTUAL(1)	FY 1981 ACTUAL(2)	FY 1982 ENACTED*(2)	FY 1983 RECOMMENDATION(2)	CHANGE FY 1982 TO 1983 DOLLAR	CHANGE FY 1982 TO 1983 PERCENT
National Total:						
Budget Authority	$ 2,430.0	$ 4,585.0	$ 3,432.0	$ 3,089.0	$ 343.0	(10.0)
Budget Outlay	4,022.0	4,408.9	3,816.9	3,282.0	(534.9)	(14.0)
State of Michigan						
Est. Allocation	87.0	95.3	82.4	70.9	(11.5)	(14.0)

PROGRAM DESCRIPTION

The Department of Transportation administers the Mass Transit Assistance program. The program has two major components which relate directly to state and local programs. They are the Capital Assistance grants program and the Operating Assistance program. The Capital Assistance Grants program provides funds to grant recipients for capital projects. These funds are usually transmitted directly from the federal government to local transit authorities and do not come through the state treasury. The federal funds usually make up 75% to 100% of the cost of a capital project with the match coming from state and local sources. The Operating Assistance program provides funds for the day to day operating expense of local transit authorities. The federal funds flow directly to the transit authorities. The assistance provides approximately 1/3 of the operating costs of transit operators with 1/3 coming from the state and 1/3 coming from local sources, which include fare box revenues.

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(1) Source: "Geographic Distribution of Federal Funds".

(2) Source: "Budget Appendix". Budget outlays represent budget obligations. As specified in object code 41.0.

PRESIDENT'S RECOMMENDATION AND SFA ANALYSIS OF IMPACT ON STATE OF MICHIGAN

The President's recommendation can be summarized in one statement from his budget proposal: "These changes are part of the larger effort to return responsibility and decision-making to State and local governments, to retarget public sector capital improvement programs, and to eliminate subsidies that encourage inefficiency in program operations."

Capital assistance grants: The funding level for capital assistance grants is recommended to continue at near the 1982 level. New construction of rail systems will continue to be postponed and only modernization and rehabilitation of existing, proven transit systems will be emphasized. The president is also recommending that local authorities have discretion in allocating funds from cancelled Interstate highway projects be made available for new rail systems. This would seem to leave the door open for some creative ideas in financing a light rail system and the people mover system in Detroit.

Operating assistance grants: The president is proposing the phasing out of operating assistance over the next three years (beginning in 1983). The president's proposal would reduce operating assistance to 62% of 1982 levels. As mentioned before, the federal funds provide approximately 1/3 of the total operating budget of local transit authorities. With the proposed elimination of federal funds, the local authorities have four options; 1) to hope that State government can replace the federal funds; 2) to raise local support by either increasing fares or a new local taxing mechanism; 3) reducing service; or 4) a combination of the first three alternatives. The most likely outcome of the federal subsidy elimination will be a reduction in service or total elimination of local transit authorities.

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SENATE FISCAL AGENCY FEDERAL BUDGET ANALYSIS

STATE AND COMMUNITY HIGHWAY SAFETY
(dollars in millions)

FINANCIAL OVERVIEW

	FY 1980 ACTUAL(1)	FY 1981 ACTUAL(2)	FY 1982 ENACTED(2)	FY 1983 RECOMMENDATION(2)	CHANGE FY 1982 TO 1983	
					DOLLAR	PERCENT
National Total:						
Budget Authority	$ ---	$ 12.6	$ -0-	$ -0-	$ -0-	0
Budget Outlays	187.5	173.8	100.1	74.6	(25.5)	(25.5)
State of Michigan Est. Allocation	7.5	6.9	4.0	3.0	(1.0)	(25.0)

PROGRAM DESCRIPTION

This program is administered by the Federal Department of Transportation National Highway Safety Administration (DOT-NHTSA).

The Michigan Highway Safety Planning program in the Department of State Police, which is responsible for the development, coordination and administration of grants to local and state government agencies, is supported by the above federal grant. Funds are also appropriated to the Department of State and Transportation for highway safety related purposes.

Federal support for this program has been provided since 1966.

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(1) Source: "Geographic Distribution of Federal Funds".

(2) Source: Outlays shown are for obligations. Budget Appendix, Object Code 41.0, Obligations.

Reduction of this program would have minimal affect on the state's highway safety program since it represents only 2% of the total expenditures for highway safety annually in the state.

It is impossible to estimate the number of clients or persons affected by reduction of this program, but grants for these purposes would be reduced from approximately 100 to 150 annually to 75 to 90.

The objective of the program is to provide grants to states and communities to implement and maintain highway safety standards.

The program is a 75/25 matching program including soft match of staffing and services.

PRESIDENT'S RECOMMENDATION

The President's policy is to provide more funds for maintenance of the country's interstate highway system and since the gasoline tax revenues are declining, funding for this program had to be reduced.

The reduction of this program for 1983 will result in a loss of $2 million funding nationally and $100,000 on the state level.

The department has been reducing the administrative staff through attrition and does not foresee the need for any layoffs.

SFA ANALYSIS OF IMPACT ON THE STATE OF MICHIGAN

Because this program is only 2% of the overall highway safety effort, the effects of the reduction will be very minimal to the state wide highway safety effort, but will greatly reduce efforts by the Michigan departments of State Police, State and Transportation.

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FUNCTION 450

COMMUNITY & REGIONAL DEVELOPMENT

SENATE FISCAL AGENCY FEDERAL BUDGET ANALYSIS

COMMUNITY DEVELOPMENT BLOCK GRANT (CDBG)

(dollars in millions)

FINANCIAL OVERVIEW

	FY 1980 ACTUAL**	FY 1981 ACTUAL**	FY 1982 ENACTED	FY 1983 RECOMMENDATION	CHANGE FY 1982 TO 1983 DOLLAR	CHANGE FY 1982 TO 1983 PERCENT
National Total*						
Budget Authority	$ ---	$ ---	$ 3,456.0	$ 3,456.0	$ -0-	-0-
Budget Outlays	3,685.9	3,710.4	4,005.0	3,350.0	(655.0)	(16.3)
State of Michigan						
Est. Allocation*	156.6	157.6	144.9	144.9	-0-	-0-

*The amounts listed for national totals and for the State of Michigan include both the entitlement and small cities portions of the block grant. In fiscal year 1982, Michigan's allocation was divided as follows: a) Entitlement - $114,429,000; and b) Small cities - $30,506,000. The small cities figure encompasses multiyear commitments of $8,644,000.

**Source: Geographical Distribution of Federal Funds.

PROGRAM DESCRIPTION

The Community Development Block Grant (CDBG) program was created in 1974 as a consolidation of several categorical grant programs that were administered by the Department of Housing and Urban Development (HUD) including: urban renewal, neighborhood development, Model Cities, water and sewer facilities, public facilities, and urban beautification programs. The primary objective of the CDBG program is to foster "the development of viable urban communities, by providing decent housing and a suitable living environment, and expanding economic opportunities, principally for persons of low and moderate income". Until fiscal year 1982, the CDBG was entirely a local government program with dollars distributed by HUD on a formula basis to urban counties and to cities with populations in excess of 50,000, and on a project-by-project discretionary basis to small cities.

In fiscal year 1982, for the first time, HUD allowed each state government the option of designing and administering a small cities program focused on the most critical needs of its own small cities; HUD continued to administer the entitlement portion of the CDBG. In Michigan, the Governor designated the Department of Commerce's Office of Community Development (OCD) as the administrator of the program. The OCD has proceeded to conduct fourteen regional workshops and several public hearings to obtain local input regarding the new Small Cities Grant (SCG). The OCD has identified two primary objectives for the SCG program:

a) To support and enhance economic recovery efforts in Michigan communities by creating new jobs, retaining existing jobs, and improving the local tax base; and

b) To help the state's small and rural communities conserve and expand their housing stock.

The OCD has also formulated proposed guidelines for the program which address eligibility of applicants, types of applications, and criteria for both the economic development and housing portions of the SCG. Currently, no SCG dollars have been received or expended by Michigan for fiscal year 1982, pending promulgation of final HUD regulations governing the state-administered non-entitlement CDBG program. Interim HUD regulations, issued November 20, 1981, were designed to support the responsibility and flexibility of individual states in administering their own programs, establishing the policies for the programs, distributing funds to recipients, and reviewing the performance of those recipients. For example, the interim regulations do not contain a definition of the term "low-and-moderate-income families", and do not prescribe cost principles and other financial management procedures for states administering the SCG. The interim regulations have generated criticism from the U.S. House of Representatives' Subcommittee on Housing and Community Development and from the National League of Cities, among others. Final regulations are expected by the end of February, 1982.

PRESIDENT'S RECOMMENDATION

The President has recommended $3.456 billion nationally for the CDBG for fiscal year 1983, a budget authority identical to that of fiscal year 1982. In general, states will receive the same amount for 1983 as they received in 1982: for Michigan, this translates to $114,429,000 for entitlement communities and $30,506,000 for small cities.

Administrative requirements for the states would include:

a) Submission of Governor's certifications for non-entitlement community planning and local consultation, and Governor's final statement;

b) Provision of a 10% state match for the SCG which could be cash or in-kind existing programs in community development; and

c) Submission of performance report.

A state could use up to 2% of the small cities funds for administrative purposes but would have to match the administrative money on a 50/50 basis. It is unclear as to whether or not existing administrative dollars may constitute this match. The Governor's recommendation for 1982-83 includes $527,100 in new General Fund dollars as a state match for the SCG; the necessity of this new state funding is questioned, particularly since current state funding within the Office of Economic Development alone amounts to $7,505,900.

SFA ANALYSIS OF IMPACT ON STATE OF MICHIGAN

Although the fiscal year 1983 funding level for the CDBG remains the same as that of 1982, the CDBG is still a consolidation of community development grants and planning grants. In 1979-80, Michigan received $156.58 million for both the CDBG and planning grants; therefore, the 1983 allocation of $144.93 million represents a decrease of 7.4% from 1979-80. Michigan is experiencing this loss of funding at a time when economic conditions in the state are deteriorating. Table 1 presents a six-year funding history of the CDBG for both Michigan and the nation; the table is illustrative of the declining amount of Federal dollars in fiscal years 1982 and 1983.

TABLE 1. SIX YEAR FUNDING HISTORY OF THE CDBG*
(dollars in millions)

Year	77-78	78-79	79-80	80-81	81-82	82-83
Grant Amount						
Nation	$ 2,930.4	$ 3,554.3	$ 3,685.9	$ 3,710.4	$ 3,456.0	$ 3,456.0
Michigan	125.4	149.7	156.6	157.6	144.9	144.9
Mich. % Nation	4.3%	4.2%	4.2%	4.2%	4.2%	4.2%
Mich. % Change increase/(decrease) from prior year	---	19.3%	4.6%	0.6%	(7.4%)	0.0%

*Source: Geographical Distribution of Federal Funds.

Data obtained from the Northeast-Midwest Institute ("The Community Development Block Grant Formula: Are Further Changes Needed?", June, 1980) indicates that of the total national CDBG program for 1979-80, regional percentage shares were as follows:

a) Northeast - 28.6%
b) South - 26.2%
c) West - 23.7%
d) Midwest - 21.5%

Even when CDBG funds were at the higher 1979-80 levels, the Midwest received the lowest percentage share (21.5%) of all regions.

HUD provides the option for states to assume the SCG in 1982 or in 1983. If a state does not elect to administer the SCG, HUD would continue to serve as administrator. HUD has indicated, however, that by 1984 they expect mandatory state assumption of the SCG, as a part of the "New Federalism".

If a state does assume the SCG, additional assistance may be available from HUD in the following areas:

(a) Direct 107 Technical Assistance Grants will be offered to states who will administer the SCG; funds would be used to start, train, and assume the program.
(b) Two- or three-day training sessions on program design and implementation will be offered by HUD to state and local officials; topics to be covered would range from availability of other state and Federal funds to targeting of funds.
(c) Regional sessions will be conducted regarding federal requirements.
(d) A National Clearinghouse will be developed to disseminate block grant information.
(e) Specialized technical assistance may be offered which would focus on such things as public participation, economic development, or training sessions for individual states.

Michigan may wish to pursue at least one of the aforementioned assistance offers before implementation of the SCG program.

If the SCG is, in fact, accepted for implementation, details regarding state administration of the program would require further discussion between the executive and legislative branches of Michigan government. Several administrative proposals have been advanced, including those of the Michigan Council on Intergovernmental Relations (MCIR) and the Michigan Department of Commerce (MDOC) with respective focuses on regional (MCIR) and state (MDOC) administration. In addition, decisions regarding distribution of SCG dollars among various activities (economic development, housing, public works) have yet to be made. Table 2 delineates former spending priorities of the CDBG but these would not necessarily dictate current allocation of funds. Clearly, promulgation of final HUD regulations and decision-making at the state level are required prior to full implementation of the CDBG.

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TABLE 2. PERCENT OF CDBG GRANTS SPENT FOR SELECTED ACTIVITIES BY CITY CHARACTERISTICS: FISCAL YEARS 1975 AND 1978

City Characteristic[a]	1975				1978			
	Housing and Code Enforcement	Public Works[b]	Services and Related Facilities	Economic Development[c]	Housing and Code Enforcement	Public Works[b]	Services and Related Facilities	Economic Development[c]
Percent Persons Below Poverty								
Low (1.0-7.2)	16.6	23.3	8.7	0.6	21.0	27.4	9.7	0.0
Medium (7.3-10.6)	14.4	19.2	17.3	0.9	24.6	26.3	16.2	0.9
High (10.7 and over)	11.4	24.0	17.2	0.9	17.7	33.1	13.5	1.3
Percent Pre-1939 Housing Units								
Low (0-22.4)	11.4	35.1	8.3	0.0	16.9	33.9	12.9	0.0
Medium (22.8-48.3)	10.2	22.2	17.0	0.7	20.2	30.2	13.4	0.9
High (48.4 or more)	16.9	19.1	16.0	1.1	22.6	27.6	14.4	1.0
Percent Population Growth (1960-1975)								
Fast (11 or more)	11.4	29.6	11.6	0.0	20.4	36.3	8.5	0.3
Slow (0-11)	11.1	17.9	22.2	2.0	17.9	21.2	24.0	1.0
Decline	15.1	17.0	16.4	1.0	22.1	28.0	13.6	1.7
Percent Overcrowded Housing Units								
Low (0-5.5)	17.3	23.0	14.0	0.1	27.8	29.8	11.0	0.2
Medium (5.6-8.0)	14.8	25.2	11.0	0.5	20.0	29.6	11.6	1.1
High (8.1 or more)	10.3	19.2	20.3	1.5	18.2	29.1	16.6	1.1
City Population								
Less than 50,000	9.2	27.9	12.0	0.0	16.8	32.1	12.5	0.2
50,000 to 100,000	14.3	27.9	18.2	0.7	22.6	38.7	10.5	0.8
100,000 to 500,000	14.9	20.9	13.3	0.9	22.2	26.5	11.7	1.0
Over 500,000	11.0	14.1	26.4	1.9	18.1	26.4	23.6	0.9

SOURCE: HUD evaluation sample; calculations performed by CBO.

NOTE: Percents do not add to 100 because spending on clearance and demolition and program administration is not tabulated.

a. Not all cities are represented in each project category because values for some city characteristics are lacking. Cutoff points for city characteristics (except population growth) were chosen so that one-third of the sample would fall into each category.

b. Includes water, sewer, and neighborhood facilities.

c. Does not include related publicly financed infrastructure improvements.

FUNCTION 500

EDUCATION, TRAINING, EMPLOYMENT & SOCIAL SERVICES

SENATE FISCAL AGENCY FEDERAL BUDGET ANALYSIS

BILINGUAL EDUCATION
(dollars in millions)

FINANCIAL OVERVIEW

	FY 1980 ACTUAL	FY 1981 ACTUAL	FY 1982 ENACTED	FY 1983 RECOMMENDATION	CHANGE FY 1982 TO 1983 DOLLAR	CHANGE FY 1982 TO 1983 PERCENT
National Total:						
Budget Authority	NA	$ 161.427	$ 138.057	$ 94.534	$ (43.523)	(31.5)
Budget Outlays	NA	$ 172.833	$ 151.890	$ 145.831	$ (6.059)	(4.0)
State of Michigan Est. Allocation	$ 3.308	$ 2.687	$ 2.284	$ 1.622	$ (.662)	(29.0)

PROGRAM DESCRIPTION

Bilingual Education is administered by the Department of Education. The program supports bilingual education programs in local schools for children of limited English speaking ability for the purpose of improving their ability to develop subject matter skills. The program also supports training of bilingual education personnel; studies and evaluations; development, assessment and disseminaton of instructional materials. Michigan provides an additional $3.150 in state monies.

PRESIDENT'S RECOMMENDATION

Nationally, it is estimated in 1983-84 370 classroom projects will be supported, including 47 special demonstration projects involving 169,890 children; provide inservice for 14,700 teachers and other staff; provide undergraduate training for 3,960 potential bilingual teachers and administrators; support training programs in 110 institutions of Higher Education; and aid 49 state education agencies in providing technical assistance and coordination.

SFA ANALYSIS OF IMPACT ON STATE OF MICHIGAN

For 1980-81 there were 10 districts funded with federal funds (an additional 65 districts received state funds only). In these districts a total of 20,805 students were funded with both federal and state monies (not all these students received federal funds).

Under the funding system, the reduction in federal funds would mean districts will receive less money per pupil; however, no pupil will be eliminated due to the reduced funding.

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SENATE FISCAL AGENCY FEDERAL BUDGET ANALYSIS

COMMUNITY SERVICES BLOCK GRANT (CSBG)
(dollars in millions)

FINANCIAL OVERVIEW

	FY 1980 ACTUAL*	FY 1981 ACTUAL*	FY 1982 ENACTED	FY 1983 RECOMMENDATION	CHANGE FY 1982 TO 1983 DOLLAR	CHANGE FY 1982 TO 1983 PERCENT
National Total						
Budget Authority	$ ---	$ ---	$ 336.5	$ 100.0	$ (236.5)	(70.3)
Budget Outlays	982.4	483.3	311.2	150.5	(160.7)	(51.6)
State of Michigan						
Est. Allocation	36.0	17.7	13.3	3.9	(9.4)	(70.7)

* Source: Geographical Distribution of Federal Funds.

PROGRAM DESCRIPTION

The 1981-82 Presidential budget eliminated the Community Services Administration (CSA) and created an Office of Community Services within the Department of Health and Human Services (DHHS). A separate block grant was established for programs formerly funded by the CSA. The Community Services Block Grant (CSBG) restructured a single categorical program, the Community Action Program, which had been established by the Economic Opportunity Act of 1964. The programs consolidated into the CSBG included community action, community food and nutrition, training and technical assistance, and State Economic Opportunity Offices.

CSBG funds must be used "to ameliorate the causes of poverty in communities within the state". More specifically, the funds must be utilized to:

a) Provide a range of services and activities having a major impact on causes of poverty;
b) Provide activitites designed to assist low-income participants (including elderly poor) in employment, education, housing, and emergency situations; and
c) Encourage self-sufficiency, community involvement, effective use of related poverty programs and the involvement of the private sector in these efforts.

The Governor has designated the Department of Labor's Bureau of Community Services (BCS) as Michigan's administrator of the CSBG program. The BCS has statutory authority (P.A. 230 of 1981) to coordinate state activities designed to reduce poverty and to implement community social and economic programs; the BCS already administers a state grant to community action agencies (CAA's) (1981-82 grant amount: $1.07 million).

The direct delivery of CSBG services to the state's low-income residents would be primarily through CAA's. The thirty CAA's in Michigan, with a combined fiscal year 1981 budget of approximately $163 million, employed over 9,000 people both full and part-time, actively involved over 23,000 volunteers, and provided services to approximately 322,000 low-income households throughout the state. CSBG programs will be operated at the local level by CAA's which geographically serve all 83 counties in the state. The BCS will provide the contracted agencies with training and technical assistance, monitoring, evaluation, policy development, allocation of funds, and supervision of financial audits.

To date, the Michigan Legislature has not appropriated 1981-82 dollars for the CSBG but BCS has funded short-term CSBG contracts from existing state appropriations.

PRESIDENT'S RECOMMENDATION

The President has recommended $100 million nationally for the CSBG for fiscal year 1983, a budget authority 70.3% lower than that of fiscal year 1982. For Michigan, this translates to a 1983 allocation of only $3.9 million, a reduction of 70.7% from the 1982 funding level.

State CSBG funds are subject to a number of administrative restrictions, including:

a) Submission of written application and assurances that the state will abide by the constraints of the program;
b) Preparation and timely submission of annual plan and report;
c) Conduction of a public hearing to explain distribution of funds;
d) For fiscal year 1983 and thereafter, not less than 90% of the funds must be distributed to either private non-profit community organizations (states must give "special consideration" to existing CAA's) or political subdivisions of the state;
e) A state may expend no more than 5% of its allotment for administration (for Michigan, $195,000); and
f) Funds cannot be used to buy or improve land or buildings, except for energy-related weatherization and repair.

Although there is no state match required by the DHHS, the BCS will require a 20% local match for CSBG funds.

SFA ANALYSIS OF IMPACT ON STATE OF MICHIGAN

In prior years, CSA funding had traditionally been divided into the following four categories:

a) Local initiative funding, core funding for community action agencies;
b) Administrative funding;
c) Funding for state economic opportunity offices; and
d) Funding for other programs, such as, senior services and community food and nutrition.

Allocations to the states under the CSBG are based on the percentage of local initiative funds the state received in 1981, rather than a percentage of total CSA funds available to the state under the four categories. In 1980-81, Michigan received a total of $20 million from CSA; only $14.7 million of that amount was local initiative funding. Since Michigan was maintaining a 3.913% national share of the local initiative CSA funding in 1981, its allocation for 1983 would be approximately $3.9 million ($100.0 x 3.913% = $3.9), a 70.7% reduction from 1981-82. This substantial reduction in community programs for low-income persons is extremely untimely for Michigan and is even more damaging when viewed in light of historical funding for community action programs. Table 1 below, a six-year funding summary of community services programs, illustrates the severity of the impact; the CSBG 1982-83 funding level represents a 90% reduction from 1979-80 community service resources.

TABLE 1. SIX YEAR FUNDING HISTORY OF THE CSBG*
(dollars in millions)

Year	77-78	78-79	79-80	80-81	81-82	82-83
Grant Amount						
Nation	$ 784.4	$ 711.6	$ 982.4	$ 483.3	$ 336.5	$ 100.0
Michigan	26.2	24.7	36.0	17.7	13.3	3.9
Mich. % Nation	3.3%	3.5%	3.7%	3.7%	3.9%	3.9%
Mich. % Change increase/(decrease) from prior year	---	(5.7%)	45.7%	(50.8%)	(63.1%)	(70.7%)

---

*Source: Geographical Distribution of Federal Funds.

In addition to consolidating community action programs into the CSBG, the 1983 Presidential budget recommends eliminating the Legal Services Corporation which funds state and local agencies that provide free civil legal assistance to the poor, and utilizing Social Service Block Grant and CSBG dollars to fund legal services activities states may wish to provide. This action strains even further the available dollars for community services.

Michigan could choose not to administer the CSBG program and allow resumption of operations by DHHS. For any quarter in which the DHHS administers the CSBG, administrative costs of DHHS would be deducted from the state's allotment. As of November 1, 1981, fourteen states, including New York, Florida, Texas, Maryland, and California had decided not to administer the CSBG.

If Michigan does implement the CSBG, there will be policy input from both the executive and legislative branches of government as mandated by the newly enacted "Michigan Economic and Social Opportunity Act of 1981" (P.A. 230 of 1981). The act provides statutory authority for the BCS and establishes a Commission on Economic and Social Opportunity within the Department of Labor which would serve as a statewide forum concerning state policies and programs to reduce poverty and to address the needs of low-income people in the state. Sec. 19 of the act requires the legislature to conduct public hearings on the proposed use and distribution of CSBG funds. The legislature must also approve or disapprove, by concurrent resolution, the BCS's plan for distribution of CSBG funds.

Since the distribution of funds for fiscal year 1983 can encompass a broader base than just existing CAA's (other nonprofit community organizations or political subdivisions of the state), legislative discussion will most likely focus on the distribution aspect. Table 2 on the following page is the tentative 1981-82 allocation schedule devised by BCS for distribution of CSBG funds to CAA's. The table is based on a total state allocation of $13.86 million; the actual 1981-82 allocation will be closer to $13.3 million and the proposed allocation for 1982-83 would be only $3.9 million.

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TABLE 2. TENTATIVE ALLOCATION SCHEDULE (Based on Tentative CSBG State Allocation of $13,866,000)

COMMUNITY ACTION AGENCY	(1) CSA FY'81 01 & 05 Level	(2) Average Mo. FY'82 Funding	(3) CSA Funding Ending	(4) Months to 9/30/82	(5) CSBG Allocation (2x4)	(6) 20% Match	(7) Total CSBG And Match	(8) CSA FY'82 Funding (1-3)	(9) 20% Required CSA Match	(10) Total CSBG/ CSA + Match
Alger Marquette CAP	$ 150,000	$ 12,500	9-30-82	-0-	$ -0-	$ -0-	$ -0-	$ 150,000	$ 30,000	$ 180,000
Allegan County HRC	125,000	10,420	2-28-82	7	73,000	14,600	87,600	52,000	10,400	150,000
Baraga-Houghton-Keweenaw CAA, Inc.	150,000	12,500	9-30-82	-0-	-0-	-0-	-0-	150,000	30,000	180,000
Berrien County Action	150,000	12,500	6-30-82	3	37,500	7,500	45,000	112,500	22,500	180,000
CAA of South Central Michigan	175,000	14,500	10-31-81	9	131,250	26,250	157,500	43,750	8,750	210,000
Capital Area Community Services	296,000	24,670	3-31-82	6	148,000	29,600	177,600	148,000	29,600	355,200
Dickinson-Iron County CAA	150,000	12,500	9-30-82	-0-	-0-	-0-	-0-	150,000	30,000	180,000
Eastern Upper Peninsula HRA	150,000	12,500	9-30-82	-0-	-0-	-0-	-0-	150,000	30,000	180,000
Eight-CAP, Inc.	150,000	12,500	12-31-81	9	112,500	22,500	135,000	37,500	7,500	180,000
Five-CAP, Inc.	150,000	12,500	10-31-81	11	137,500	27,500	165,000	12,500	2,500	180,000
Genesee County CAA	310,000	25,830	7-31-82	2	51,700	10,340	62,000	258,300	51,700	372,000
Gogebic-Ontonagon CAA	150,000	12,500	9-30-82	-0-	-0-	-0-	-0-	150,000	30,000	180,000
Human Development Commission	150,000	12,500	1-31-82	8	100,000	20,000	120,000	50,000	10,000	180,000
Kalamazoo County HRC	215,000	17,920	6-30-82	3	53,750	10,750	64,500	161,250	32,250	258,000
Kent Community Action Program	551,000	45,920	9-30-81	12	551,000	110,200	661,200	-0-	-0-	661,200
Menominee-Delta-Schoolcraft	150,000	12,500	9-30-82	-0-	-0-	-0-	-0-	150,000	30,000	180,000
Macomb County CSA	347,000	28,910	9-30-81	12	347,000	69,400	416,400	-0-	-0-	416,400
Mid-Michigan Alliance for Community Development	293,000	24,420	12-31-81	9	219,750	43,950	263,700	73,250	14,650	351,600
Monroe County Opportunity Program	150,000	12,500	11-30-81	10	125,000	25,000	150,000	25,000	5,000	180,000
Muskegon-Oceana CAAP, Inc.	297,000	24,750	11-30-81	10	247,500	49,500	297,000	49,500	9,900	356,400
Neighborhood Services Department	7,683,000	640,250	9-30-81	12	7,683,000	1,536,600	9,219,600	-0-	-0-	9,219,600
Northeast Michigan CSA	194,000	16,170	11-30-81	10	161,670	32,330	194,000	32,330	6,470	232,800
Northwest Michigan HRA	198,000	16,500	3-31-82	6	99,000	19,800	118,800	99,000	19,800	237,600
Oakland Livingston HRA	920,250	76,690	9-30-81	12	920,250	184,050	1,104,300	-0-	-0-	1,104,300
Region II Community Action Agency	175,000	14,580	3-31-82	6	87,500	17,500	105,000	87,500	17,500	210,000
Saginaw County CAC, Inc.	150,000	12,500	2-28-82	7	87,500	17,500	105,000	62,500	12,500	180,000
St. Clair County EOC	150,000	12,500	8-31-82	1	12,500	2,500	15,000	137,500	27,500	180,000
Washtenaw County CSA	150,000	12,500	10-31-81	11	137,500	27,500	165,000	12,500	2,500	180,000
Wayne Metropolitan CSA	525,000	43,750	9-30-81	12	525,000	105,000	630,000	-0-	-0-	-0-
TOTALS:	$ 14,405,250	$ 1,200,350	N/A	N/A	$12,044,670	$ 2,410,070	$14,454,800	$ 2,356,000	$ 471,130	$ 17,286,370

SOURCE: Michigan Department of Labor, Bureau of Community Services

TABLE 2. TENTATIVE ALLOCATION SCHEDULE (Based on Tentative CSBG State Allocation of $13,068,000)

COMMUNITY ACTION AGENCY	(1) CSA FY'81 01 & 05 Level	(2) Average Mo. FY'82 Funding	(3) CSA Funding Ending	(4) Months to 9/30/82	(5) CSBG Allocation (2x4)	(6) 20% Match	(7) Total CSBG And Match	(8) CSA FY'82 Funding (1-5)	(9) 20% Required CSA Match	(10) Total CSBG/CSA + Match
Alger Marquette CAP	$ 150,000	$ 12,500	9-30-82	-0-	$ -0-	$ -0-	$ -0-	$ 150,000	$ 30,000	$ 180,000
Allegan County ROC	125,000	10,420	2-28-82	7	73,000	14,600	87,600	52,000	10,400	150,000
Baraga-Houghton-Keweenaw CAA, Inc.	150,000	12,500	9-30-82	-0-	-0-	-0-	-0-	150,000	30,000	180,000
Berrien County Action	150,000	12,500	6-30-82	3	37,500	7,500	45,000	112,500	22,500	180,000
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Capital Area Community Services	296,000	24,670	3-31-82	6	148,000	29,600	177,600	148,000	29,600	355,200
Dickinson-Iron County CAA	150,000	12,500	9-30-82	-0-	-0-	-0-	-0-	150,000	30,000	180,000
Eastern Upper Peninsula HRA	150,000	12,500	9-30-82	-0-	-0-	-0-	-0-	150,000	30,000	180,000
Eight-CAP, Inc.	150,000	12,500	12-31-81	9	112,500	22,500	135,000	37,500	7,500	180,000
Five-CAP, Inc.	150,000	12,500	10-31-81	11	137,500	27,500	165,000	12,500	2,500	180,000
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Gogebic-Ontonagon CAA	150,000	12,500	9-30-82	-0-	-0-	-0-	-0-	150,000	30,000	180,000
Huron Development Commission	150,000	12,500	1-31-82	8	100,000	20,000	120,000	50,000	10,000	180,000
Kalamazoo County HSC	215,000	17,920	6-30-82	3	53,750	10,750	64,500	161,250	32,250	258,000
Kent Community Action Program	551,000	45,920	9-30-81	12	551,000	110,200	661,200	-0-	-0-	661,200
Menominee-Delta-Schoolcraft	150,000	12,500	9-30-82	-0-	-0-	-0-	-0-	150,000	30,000	180,000
Macomb County CSA	347,000	28,920	9-30-81	12	347,000	69,400	416,400	-0-	-0-	416,400
Mid-Michigan Alliance for Community Development	293,000	24,420	12-31-81	9	219,750	43,950	263,700	73,250	14,650	351,600
Monroe County Opportunity Program	150,000	12,500	11-30-81	10	125,000	25,000	150,000	25,000	5,000	180,000
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Neighborhood Services Department	7,683,000	640,250	9-30-81	12	7,683,000	1,536,600	9,219,600	-0-	-0-	9,219,600
Northeast Michigan CSA	194,000	16,170	11-30-81	10	161,670	32,330	194,000	32,330	6,470	232,800
Northwest Michigan HSA	199,000	16,580	3-31-82	6	99,500	19,900	119,400	99,500	19,900	238,800
Oakland Livingston HSA	920,250	76,690	9-30-81	12	920,250	184,050	1,104,300	-0-	-0-	1,104,300
Region II Community Action Agency	175,000	14,580	3-31-82	6	87,500	17,500	105,000	87,500	17,500	210,000
Saginaw County CAC, Inc.	150,000	12,500	2-28-82	7	87,500	17,500	105,000	62,500	12,500	180,000
St. Clair County EOC	150,000	12,500	8-31-82	1	12,500	2,500	15,000	137,500	27,500	180,000
Washtenaw County CSA	150,000	12,500	10-31-81	11	137,500	27,500	165,000	12,500	2,500	180,000
Wayne Metropolitan CSA	525,000	43,750	9-30-81	12	525,000	105,000	630,000	-0-	-0-	0
TOTALS:	$ 14,485,250	$ 1,208,250	N/A	N/A	$ 12,048,070	$ 2,410,970	$ 14,459,000	$ 2,355,300	$ 471,120	$ 17,286,370

SOURCE: Michigan Department of Labor, Bureau of Community Services

SENATE FISCAL AGENCY FEDERAL BUDGET ANALYSIS

EDUCATION OF THE HANDICAPPED BLOCK GRANT
(dollars in millions)

FINANCIAL OVERVIEW

	FY 1980 ACTUAL	FY 1981 ACTUAL	FY 1982 ENACTED	FY 1983 RECOMMENDATION	CHANGE FY 1982 TO 1983	
					DOLLAR	PERCENT
National Total:						
Budget Authority	NA	$1,025.231	$1,042.080	$ 845.668	$(196.412)	(18.8)
Budget Outlays	NA	$1,035.353	$1,273.121	$1,024.889	$(248.232)	(19.5)
State of Michigan Est. Allocation		$ 33.131	$ 33.794	$ 27.373	$ (6.421)	(19.0)

PROGRAM DESCRIPTION

This program is administered by the Department of Education. The program assists states in meeting their responsibility to provide a free public education to all handicapped children. These funds assist such programs as: state and preschool incentive grants; deaf-blind centers; severely handicapped and early childhood education projects; regional, vocational adult and postsecondary programs; innovation and development; media services and captioned films; regional resource centers; recruitment and information; special education personnel development; and special studies. During 1981-82 an additional $78.7 million of state monies was spent.

PRESIDENT'S RECOMMENDATION

For FY 1983, funds are requested to consolidate these programs with activities for education of the handicapped now funded under Chapter 1.

SFA ANALYSIS OF IMPACT ON STATE OF MICHIGAN

During 1981-82, 57 intermediate and 494 local districts provided special education programs to 158,479 pupils. The recommended funding reduction of the President would not reduce the number of pupils served, however it would reduce the amount of money per pupil. The effect of this will be a larger burden on the local taxpayer; along with reduced quality in the pupil's programs and services.

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SFA/2/18/82
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SENATE FISCAL AGENCY FEDERAL BUDGET ANALYSIS

EMPLOYMENT & TRAINING BLOCK GRANT
(dollars in millions)

FINANCIAL OVERVIEW

	FY 1980 ACTUAL	FY 1981** ACTUAL	FY 1982** ENACTED*	FY 1983** RECOMMENDATION	CHANGE FY 1982 TO 1983 DOLLAR	CHANGE FY 1982 TO 1983 PERCENT
	$	$	$	$	$	
National Total:						
Budget Authority	NA	6,070	2,373	1,800	(573)	(24.1)
Budget Outlays	8,222	5,926	3,266	1,531	(1,735)	(53.1)
State of Michigan Est. Allocation	315.5*	227.4	125.3	58.7	(66.6)	(53.2)

PROGRAM DESCRIPTION:

The Comprehensive Employment & Training Act (CETA) was established in 1973, and amended in 1978. The purpose of the legislation was to provide job training and employment opportunities for persons who were economically disadvantaged, unemployed, or underemployed. The ultimate goal of the program has been to provide coordinated services with economic and community development, and related activities such as vocational rehabilitation, public assistance, vocational education, training programs, and social services programs. The coordinated programs were to aid disadvantaged individuals to maximize their employment opportunities and enhance their self sufficiency. The programs are administered by the United States Department of Labor. The majority of grants are provided directly to local governmental units or consortiums, with populations over 100,000, known as prime sponsors. Small portions of the CETA funds to Michigan Department of Labor to administer the "Balance of State" operations. An additional grant comes directly to the Governor; this is known as the "Governor's Special Grant". CETA funds come to the state and prime sponsors for various titles and operations.

* Source: "Geographic Distribution of Federal Funds".
** Source: Special Analysis H, Federal Aid to State and Local Governments.

PRESIDENT'S RECOMMENDATION

The President's recommendation is to eliminate all grants to prime sponsors. However, legislation is proposed to consolidate training programs through a block grant to states for training services. Under the proposed block grants, all stipends to participants would be eliminated. Public sector involvement in training and employment would also be eliminated.

Secondly, a small training program will also be administered from Washington. Its purpose will be to provide training for specific groups of people, particularly, those who have difficulty in finding and retaining work. Those specified were older Americans, migrants, Indians, and those eligible for Trade Adjustment Assistance benefits.

Thirdly, The only program under the CETA that will be operational after Sept. 30, 1982, will be Title IV B, the Job Corps. Presently, under this title, residential and nonresidential centers are established in which enrollers can participate in intensive educational programs, vocational training, work experience, and counselling. The President's recommendation is to continue the Job Corps residential training program. Its aim will be to provide basic literacy and arithmetic skills and vocational training for severly educationally and economically disadvantaged youth between the ages of 16-21. The program is to be significantly reduced.

In 1983, the administration is proposing that only 55 centers nationwide be operated by states and localities. They would serve approximately 60,000 economically disadvantaged, unemployed, and out-of-school youth.

SFA ANALYSIS OF IMPACT ON STATE OF MICHIGAN

In Michigan for the fourth quarter in fiscal year 1981, there were 88,916 participants in various CETA programs across the state. Of this amount, 52% were male, and 48% female. The majority of persons were between 22 and 44 years of age. Of the total number of participants, only 56% had no income other than CETA stipends. The chart on the following page indicates the profile of CETA participants in the State.

There are nine basic program titles under which money comes to Michigan for Employment and training operations. Title II B/C are CETA which are designated for the Economically Disadvantaged, and for upgrading and retraining individuals. In 1980, Michigan received $100.2 million and in 1981, the State received $118.9 million to operate these two titles alone. Through these two titles alone, 27,000 individuals were placed in training programs (vocational and others).

Under the 1983 Reagan budget proposal, $900 thousand in block grants would go to states to be used for training grants. Based on past allocations, it appears that Michigan would probably receive $34.2 thousand to be used for training. Substantially more funds have been received through Title II alone. In Michigan the aggregate cost for training CETA participants for 1981 is $2,461. Based on the proposed budget for the training block grant, only about fourteen individuals could be trained. This would mean a reduction of 85% in the programs as we know them.

Michigan Participant Characteristic Chart:

	Title II B/C	Title II D	Title VI
White	65%	67%	72%
Black	29%	28%	24%
Hispanic	4%	3%	2%
Indian	1%	1%	2%
Asian	1%	1%	
LABOR STATUS			
Under Employed	3%	1%	1%
Unemployed	75%	85%	86%
PUBLIC ASSISTANCE STATUS			
Receiving AFDC	29%	27%	19%
SSI	3%	2%	2%
EDUCATIONAL STATUS			
Dropout	24%	23%	22%
High School (or less)	18%	1%	1%
High School Grad	41%	55%	58%
Post High School Attendee	17%	21%	19%

This indicates that when the CETA Program is terminated in Sept. 30, 1982 unless work or other viable alternatives are found, the majority of the workers will be applying for unemployment or public assistance.

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SENATE FISCAL AGENCY FEDERAL BUDGET ANALYSIS

GUARANTEED STUDENT LOAN PROGRAM
(dollars in millions)

FINANCIAL OVERVIEW

	FY 1980 ACTUAL	FY 1981 ACTUAL	FY 1982 ENACTED	FY 1983 RECOMMENDATION	CHANGE FY 1982 TO 1983 DOLLAR	CHANGE FY 1982 TO 1983 PERCENT
National Total: Budget Outlays	$ 1,598.0	$ 2,535.0	$ 2,752.0	$ 2,485.0	$ (267.0)	(9.7)
State of Michigan Est. Allocation	$ 176.6	$ 287.8	$ 200.0	$ 117.0	$ (83.0)	(41.5)

PROGRAM DESCRIPTION

The Guaranteed Student Loan Program (GSL) was established in 1965. Currently the program provides loans to college students enrolled in undergraduate and graduate programs at an annual interest rate of 9.0%. The federal government pays the interest while the student is enrolled. Repayment of the principle begins following graduation. Annual interest on unpaid principle is 9.0%. Students whose adjusted gross family income exceeds $30,000 must demonstrate financial need to be eligible. Students also pay a 5% "origination fee" which is generally added to the loan amount. In the current year, (1981-82)) approximately 102,000 students attending Michigan colleges and universities participate in the program. The average loan value is $1,960.00.

PRESIDENT'S RECOMMENDATION

- Require that all students demonstrate financial need as a condition of eligibility regardless of adjusted gross family income level.
- Increase the "origination fee" from 5% to 10% with payment due upon receipt of the loan.

- Require students to repay loans at market rates (rather than at 9% interest) two years after leaving college.

- Eliminate all students enrolled in graduate and graduate professional programs from GSL eligibility. (These students would still be eligible to borrow from the "Auxilliary Loan Program". However, the annual interest rate would be 14%, and repayment of principle and interest would begin within 60 days after receipt of the loan.)

SFA ANALYSIS OF IMPACT ON STATE OF MICHIGAN

- The total volume of Michigan GSL loan activity would decline from $200,000,000 to an estimated $117,000,000 or (41.5%).

- The total number of participating Michigan GSL students would drop from 102,000 to 65,000 (a 36.3% reduction in participation rates).

- Aproximately 20,000 graduate and graduate professional Michigan students who annually participate in the GSL program would no longer be eligible.

Summary: The anticipated reduction of 36,000 Michigan student GSL participants is made up of 20,000 graduate students and 16,000 undergraduate students. Those provisions of the President's recommendation which will have the greatest negative impact on Michigan are as follows in order of priority:

1. Elimination of graduate student eligibility.
2. Required financial needs analysis of all students regardless of family income group.
3. Required payment of 10% "Origination Fee" at time of loan receipt.

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SENATE FISCAL AGENCY FEDERAL BUDGET ANALYSIS

IMPACT AID
(dollars in millions)

FINANCIAL OVERVIEW

	FY 1980 ACTUAL	FY 1981 ACTUAL	FY 1982 ENACTED	FY 1983 RECOMMENDATION	CHANGE FY 1982 TO 1983 DOLLAR	CHANGE FY 1982 TO 1983 PERCENT
National Total:						
Budget Authority	NA	$ 757.000	$ 456.000	$ 287.000	$(169.000)	(37.1)
Budget Outlays	NA	$ 753.000	$ 645.000	$ 403.000	$(242.000)	(37.5)
State of Michigan						
Est. Allocation	$ NA	$ 6.710	$ 3.743	$ 2.358	$ (1.385)	(37.0)

PROGRAM DESCRIPTION

The Impact Aid program provides aid to local school districts whose local revenues are deemed to have been reduced by the presence of federal property. Payments are made directly to local school districts and used for operating expenses and, in some cases, for construction and emergency repairs to school buildings. Payments are currently made to approximately 2,000 school districts on behalf of children who reside and/or whose parents work on federal property or are in the military.

PRESIDENT'S RECOMMENDATION

In 1983, Impact Aid will:

- Pay school districts only for those chldren who live on federal property and whose parents work on federal property or are in the military. ("A" children; children with either but not both attributes are "B" children.)

- Provide for emergency repairs to school facilities only on Federal property.

- Payments will be made at approximately 80% of the level of payments made in 1982 for "A" children.

SFA ANALYSIS OF IMPACT ON STATE OF MICHIGAN

In FY '81 a total of 19,347 pupils were funded under Impact Aid amounting to $6.177 million. Under the President's recommendations for FY '83, less than 4,000 students will be funded, amounting to $1.678 million. The total number of participating districts in FY '81 was 48, and projected in FY '83 will be 4.

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SENATE FISCAL AGENCY FEDERAL BUDGET ANALYSIS

PELL GRANTS (FORMERLY BASIC EDUCATION OPPORTUNITY GRANTS)
(dollars in millions)

FINANCIAL OVERVIEW

	FY 1980 ACTUAL	FY 1981 ACTUAL	FY 1982 ENACTED	FY 1983 RECOMMENDATION	CHANGE FY 1982 TO 1983 DOLLAR	CHANGE FY 1982 TO 1983 PERCENT
National Total: Budget Outlays	$ 2,441.0	$ 2,346.0	$ 2,279.0	$ 1,440.0	$ (839.0)	(36.8)
State of Michigan Est. Allocation amount and year	$ 91.6 1980-81	$ 89.2 1981-82	$ 86.6 1982-83	$ 54.7 1983-84	$ (31.9)	(36.8)

PROGRAM DESCRIPTION

The Pell Grant Program (formerly entitled the Basic Education Opportunity Grant - BEOG) was established in 1972. This program is front-end funded each year. For example, 1981-82 appropriations are made for the 1982-83 academic year. The program is totally need based. At present, students from a family of four earning up to $26,000 are eligible for a PELL Grant. The number of children in college is taken into account in assessing a family's financial resources. The amount of grant awards depends upon demonstrated financial need. However, individual grants may not exceed $1,670 or 50% of a students' education cost. Prior to 1980-81 the maximum grant award ceiling was $1,800. It is estimated that approximately 96,000 students attending Michigan colleges and universities will receive PELL grants in 1982-83. Average grant value will be approximately $900.

PRESIDENT'S RECOMMENDATION

- Maximum grant awards would be reduced from $1,670 to $1,600 in 1983-84.
- Maximum annual family income ceiling for eligibility (for a family of four) would be reduced from $26,000 to $18,000.
- The number of children attending college would no longer be taken into account in assessing the family's financial resources.
- Living expenses considered in determining a student's financial need would be significantly restricted.

SFA ANALYSIS OF IMPACT ON STATE OF MICHIGAN

- The 1983-84 state allocation of PELL Grants would decline from $86.6 million to $54.7 million (a reduction of $39.9 million or 36.8%).
- The total number of Michigan students receiving PELL Grants would drop from 96,000 to 68,000 (a 29.2% reduction in participation rates).
- The average PELL Grant award amount per student would decline from $900 to $800.
- Approximately 28,000 students would no longer be eligible for PELL Grants.

Summary: Those elements of the President's recommendation which would have the greatest negative impact on Michigan are (in order of priority):

1. Reduction of family income eligibility ceiling from $26,000 to $18,000.
2. Reduction of maximum grant award ceiling from $1,670 to $1,600.
3. Removal of consideration of number of children attending college in assessing a family's financial resources.
4. Restrictions on living expense considerations in calculating a students' financial need level.

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SENATE FISCAL AGENCY FEDERAL BUDGET ANALYSIS

SOCIAL SERVICE BLOCK GRANT (TITLE XX)
(Dollars in Millions)

FINANCIAL OVERVIEW

	FY 1980 ACTUAL	FY 1981 ACTUAL	FY 1982 ENACTED*	FY 1983 RECOMMENDATION	CHANGE FY 1982 TO 1983 DOLLAR	CHANGE FY 1982 TO 1983 PERCENT
	$	$	$	$	$	
National Total:						
Budget Authority	2,888	2,399	2,400	1,974	(426)	(18%)
Budget Outlays	2,763	2,646	2,912	1,974	(938)	(32%)
State of Michigan Est. Allocation	120.1	121.4	97.4	80.1	(17.3)	(18%)

PROGRAM DESCRIPTION

The Omnibus Reconciliation Act renamed and reorganized Title XX services under the Social Services Block Grant. Title XX matches state dollars for a range of supportive services such as homemaker services, child day care, protective services, etc. Funds may also be used for administrative costs associated with such programs.

PRESIDENT'S RECOMMENDATION

States have much discretion regarding the allocation of Title XX monies. This latitude would seem to correlate with two consecutive years of large percentage decreases in federal fiscal support.

When the Block Grant concept originated, a 20% reduction in funding was included for FY 82. The President adds another 18% reduction for FY 83.

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* Reflects projected appropriated level of funding.

SFA ANALYSIS OF IMPACT ON STATE OF MICHIGAN

Michigan will lose approximately $33 million in Title XX monies in FY 1982. Assuming passage of the President's recommendation would result in an additional loss of $17 million--together for a net loss in the two years of $50 million. It is doubtful if Michigan would be in a position to continue many of the current services with 100% state funds. Instead, it would seem likely that many entire programs will be eliminated. The irony of this Executive proposal is that Title XX monies support many of the "grass-roots," volunteer-related services that the President is on record as endorsing.

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2/18/82-TITLEXX
REVISED: 2/23/82

SENATE FISCAL AGENCY FEDERAL BUDGET ANALYSIS

STATE EDUCATION BLOCK GRANT
CHAPTER 1, ECIA

FINANCIAL OVERVIEW

	FY 1980 ACTUAL*	FY 1981 ACTUAL	FY 1982 ENACTED	FY 1983 RECOMMENDATION	CHANGE FY 1982 TO 1983 DOLLAR	CHANGE FY 1982 TO 1983 PERCENT
National Total:						
Budget Authority	NA	$3,111.620	$2,892.780	$1,942.000	$(950.980)	(32.9)
Budget Outlays	NA	$3,353.595	$3,006.774	$2,882.423	$(124.351)	(4.1)
State of Michigan						
Est. Allocation	NA	$ 130.000	$ 110.000**	$ 70.200**	$(39.800)	(36.2)

PROGRAM DESCRIPTION

Chapter 1 of the Education Consolidation and Improvement Act of 1981 (ECIA) is a modification of Title I of ESEA, Education for Disadvantaged Children, or Compensatory Education. Initially enacted in 1965 with subsequent modification, its basic purpose is to provide equal educational opportunities to children with social, racial, economic or geographic handicaps or disadvantages. It has been administered by the Office of Education, HEW; currently by the U.S. Dept. of Education; and the President is recommending the abolition of the Department in 1984, to be replaced by a "Foundation for Education Assistance".

Note that Chapter 1 is forward-funded. This means that funds authorized in FY82 are expended in FY83 and the FY83 Recomendation will be expended in FY84. Because of program reductions, in several cases, outlays will exceed authority for a given year.

Also note that Chapter 1 is a formula grant based on population, the number of children in AFDC families and the number of children in institutions for neglected, delinquent or foster homes. Since the definition of

* FY 1980 figures are not comparable to suceeding years.
** These figures reflect additional reductions due to changes in state and federal eligibility requirements.

the key element, children in AFDC families is independently changed by other government agencies, the number of children eligible for Chapter 1 has dropped dramatically. Approximately 96,000 pupils receive programs under Chapter 1, of which 64,000 are AFDC children. Changes in definitions by the State and Federal governments will eliminate approximately 34,000 pupils - a loss of $10 million (est.).

For FY82, about $3.0 million of Chapter 1 funds are for state administration and resident schools. The balance of funds are expended directly by local education agenices for a wide variety of services allowable under the Act and federal regulations.

PRESIDENT'S RECOMMENDATION

Chapter 1 of ECIA will remain as one of the key programs administered by the proposed Education Foundation. The primary policy changes have already been effected within the ECIA by substantially reducing the federal regulations governing the old Title I as part of the "block grant" process which take effect on July 1, 1982. This process will be continued for the 1983-84 school year by merging the old Title I Migrant and Handicapped Education grants into Chapter 1. The key policy statement for the Chapter proposed as stated in the Federal Budget document is that "Chapter 1 funding can be reduced and still provide important aid to help the most needy".

SFA ANALYSIS OF IMPACT ON STATE OF MICHIGAN

It is crucial to bear in mind that the proposed reductions in Chapter 1 are compounded by changes in the definition of AFDC children which is the key element in the Chapter 1 funding formula. Additional cuts could result in using the 1980 federal census data, as opposed to earlier counts. Thus, the 38% cut from FY81 funding levels translates to a 46% cut of funds for Michigan. There will be losses of positions and programs in the State Dept. of Education as an inevitable elimination of administration. The brunt of dollar and program losses will be at the school district level. Most districts dependent on Chapter 1 assistance are those without the resources to continue the program. It is highly unlikely that the State will be able to make up any of the lost funding. In short, only those pupils who are "most needy" will receive services as opposed to those who are "needy". There will also be substantial staff lay-offs in larger urban areas. Substantial reductions could occur in funding education programs in correctional institutions.

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SENATE FISCAL AGENCY FEDERAL BUDGET ANALYSIS

STATE EDUCATION BLOCK GRANT
Chapter 2, ECIA

FINANCIAL OVERVIEW

	FY 1980 ACTUAL*	FY 1981 ACTUAL	FY 1982 ENACTED	FY 1983 RECOMMENDATION	CHANGE FY 1982 TO 1983 DOLLAR	CHANGE FY 1982 TO 1983 PERCENT
National Total:						
Budget Authority	NA	$ 614.471	$ 536.880	$433.000	$(103.880)	(19.3)
Budget Outlays	NA	$ 735.231	$ 670.555	$619.789	$ (50.766)	(7.6)
State of Michigan						
Est. Allocation	NA	$ 21.400	$ 18.816	$ 17.280	$ (1.536)	(8.2)

PROGRAM DESCRIPTION

Chapter 2 of the Education Consolidation and Improvement Act of 1981 (ECIA) consolidated from 24 to 46 ESEA programs (depending on how one counts the subtitles) into a single education block grant effective for the 1982-83 school year. Consistent with the President's philosophy of streamlining the federal grant system, reducing paperwork, and returning control of education to states and locals, almost all of ESEA except Title I was lumped into a single block grant with a drastic reduction in federal regulations. Of each state's allocation based on a population-driven formula, the state education agency receives 20%, and local education agencies receive 80%. This concept is a substantial change from the various separate ESEA titles which have been developed since the mid 1960's.

The block grant has three major purposes for which funds should be expended: a) basic skills development, b) educational improvement and support services, and c) special projects. Within these broad areas, there appears to be considerable latitude. State and local plans are required, but it appears that the U.S. Department of Education will review them only for basic legal compliance.

* FY80 is not comparable due to substantial changes in program mix and consolidation.

It is important to remember that the Chapter 2 Block Grant, like most federal education programs, is forward funded. This means that the FY82 appropriation will be expended during the 1982-83 school year, FY83 appropriations will be expended during the 1983-84 year. Since the funding is being reduced, outlays are presently exceeding authority.

Since the program begins on July 1, 1982, and represents such a dramatic shift in federal funding of education, its effects are not clearly known. The broad discretion at the local level makes it impossible to say how it will affect students.

PRESIDENT'S RECOMMENDATION

The first major policy change by the President was the successful enactment of the Chapter 2 Block Grant. The FY83 Budget Recommendation contains another step in the policy of reducing the federal role in education through: a) eliminating the U.S. Dept. of Education and replacing it with a much smaller "Foundation for Education Assistance", and b) turning back the bulk of education programs to the states. While budget figures for Chapter 2 are in the FY83 Recommendation, it is clear from the narrative that these programs are to be returned to the states beginning in 1984. Futher, administering the Chapter 2 Block Grant is not listed as one of the responsiblities for the proposed Education Foundation. Thus, as Chapter 2 grants are reduced during the 1983 and 1984 years, states are encouraged to assume a greater responsibility for education programs.

SFA ANALYSIS OF IMPACT ON STATE OF MICHIGAN

An analysis of the effects of the Block Grants for FY 1982-83 and the proposed reductions and "turnback" for FY 1983-84 is most difficult. We do know that the State Dept. of Education will need to undergo significant changes in its operations and focus. Planning and reorganization efforts are currently underway to meet the federal deadlines for grant awards. What makes analyses difficult is that local education agencies will be able to either continue existing programs, completely restructure them, or any combination in between. Local plans are not due until April, thus reliable information is not available.

It is highly questionable whether or not the State can assume the cost of Chapter 2 in the future, even with a federal trust fund for the purpose. Unless there is a significant change in State allocation, Chapter 2 programs will simply be eliminated or funded locally.

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SENATE FISCAL AGENCY FEDERAL BUDGET ANALYSIS

VOCATIONAL & ADULT EDUCATION BLOCK GRANT
(millions)

FINANCIAL OVERVIEW

	FY 1980 ACTUAL	FY 1981 ACTUAL	FY 1982 ENACTED	FY 1983 RECOMMENDATION	CHANGE FY 1982 TO 1983 DOLLAR	CHANGE FY 1982 TO 1983 PERCENT
National Total:						
Budget Authority $	NA	$ 781.639	$ 739.666	$ 500.000	$(239.666)	(32.4)
Budget Outlays $	NA	$ 728.428	$1,156.715	$ 525.528	$(631.187)	(54.6)
State of Michigan						
Est. Allocation $	NA	$ 29.039	$ 27.591	$ 17.895	$ (9.696)	(35.1)

PROGRAM DESCRIPTION

Adult and Vocational Education are currently separate formula grants developed in the mid sixties and administered separately. Vocational education provides for state planning and direct grants for training students for jobs and vocational careers. Adult education has the goal of reducing functional illiteracy in adults through basic education and high school completion. Michigan is currently providing $20.3 million for Voc. Ed., with the same amount recommended for FY83. Both programs are forward-funded, which is why in several cases outlays exceed authority. Over 211,000 students are currently enrolled in some form of vocational training. About one-half of the state administration money for vocational education is federal administrative grants. The Adult and Extended Learning Services area of the State Department of Education has already taken substantial cuts in federal funding as well as state dollars.

PRESIDENT'S RECOMMENDATION

The FY83 Executive Budget states only that all vocational and adult education programs will be consolidated into a single block grant. No details are given except that a simplified grant proposal will be made in a later transmittal from the President. Under the section describing the responsiblities of the Education Foundation, the Vocational-Adult Block Grant is listed as one of its functions.

SFA ANALYSIS OF IMPACT ON STATE OF MICHIGAN

Without any detail from Washington, it is difficult to understand the logic behind combining Adult and Vocational Education into a single grant. The two programs have different purposes and target groups. Vocational Education provides services and equipment for a wide variety of programs to secondary and community college students. Adult education is basically what the name implies and is targeted to those people who left school without acquiring basic skills. There is some overlap at the community college level and for displaced homemakers, but not in the basic thrust of the two programs.

Vocational education will be especially hard hit by reductions in federal funding. Local education agencies are already financing a major share of the program. Because of small pupil-teacher ratios and high equipment and overhead costs, vocational education is a relatively expensive program. The proposed reductions will reduce the number of student participants by as much as 50,000. Both programs result in providing skills to make persons more employable and productive. Thus, reductions in these programs will have a negative overall impact in the State.

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FUNCTION 550

HEALTH

SENATE FISCAL AGENCY FEDERAL BUDGET ANALYSIS

ALCOHOL, DRUG ABUSE, AND MENTAL HEALTH BLOCK GRANT
(dollars in millions)

FINANCIAL OVERVIEW

	FY 1980 ACTUAL	FY 1981 ACTUAL	EST. FY 1982 ENACTED	FY 1983 RECOMMENDATION	CHANGE FY 1982 TO 1983	
					DOLLAR	PERCENT
National Total:						
Budget Authority	---	---	$ 491.0	$ 433.0	$(58.0)	(11%)
Budget Outlays	$ 586.2	$ 548.7	432.0	432.0	-0-	-0-
State of Michigan						
Est. Allocation	$ 19.0	$ 18.8	$ 13.2	$ 13.2	-0-	-0-

PROGRAM DESCRIPTION - DEPARTMENT OF MENTAL HEALTH

The purpose of the mental health portion of this grant project administered by HHS is to provide funds to Community Mental Health Centers (CMHC's) for several specific services to the mentally ill. The services include treatment for the chronically mentally ill, mentally disturbed children and adolescents, mentally ill elderly, underserved populations, and coordination of mental health services with other health care provided through various health centers. All centers receiving Federal funds must be providing the following core services: (1) Outpatient services to children, elderly, chronically mentally ill individuals, and residents of the catchment area who have been discharged from an inpatient facility; (2) 24-hour emergency care; (3) Day treatment; (4) consultation and education; (5) screening for patients being considered for admission to State facilities to determine the appropriateness of such admission. Finally, the grants may not be used for inpatient services, cash payments to service recipients, or (without a waiver from the HHS secretary) the purchase of land, major medical equipment, or puchase or construction of buildings.

The Federal program has been present since 1963. The guidelines provide for up to eight years of funding for each CMHC. During FY 1979-80, there were approximately 8,000 - 9,000 cases served by the CMHC's.

PRESIDENT'S RECOMMENDATION - DEPARTMENT OF MENTAL HEALTH

In the past, these funds have flowed directly to the specific CMHC's. New policies will cause the funding for CMHC's to be grouped into a block grant which will flow to the State, who in turn must determine which Centers will receive funding. The guidelines create "protection" for those Centers which have not yet reached their eighth year of funding. (Protection means that the State must allocate funds to Centers in order to allow them to continue services.)

The President's recommendation for this block grant represents the same dollar amount nationally as the budget outlay for FY 1982. For the State of Michigan, the mental health portion of the FY 1983 grant would also remain approximately the same under the President's recommendation as will be received for FY 1982.

SFA ANALYSIS OF IMPACT ON THE STATE OF MICHIGAN - DEPARTMENT OF MENTAL HEALTH

Although the projected FY 1983 Federal funds for the mental health portion of this block grant would be approximately the same as the anticipated FY 1982 Federal funding, they would not be adequate to fund a continuation of the current "protected" community mental health centers. In FY 1982, the State will use the Federal block grant to fund at least three protected Centers, but in FY 1983 the state will be obligated to fund a fourth protected Center. This additional pick-up would leave an anticipated $400,000 shortfall under the President's recommendation for FY 1983. Since this grant may be carried over into the second year, the state may have to reserve approximately $400,000 from the FY 1982 funds in order to cover the projected FY 1983 shortfall. The effect of this will be that for FY 1982, funds which were to be used to fund non-protected Centers in areas that are experiencing high hospital admissions may not be available. This will further exacerbate our already higher than projected hospital populations. For FY 1983, the President's recommendations would eliminate any of the funding for community mental health centers which are not protected, and in fact, would not even cover obligated funding for the four protected centers.

PROGRAM DESCRIPTION - DEPARTMENT OF PUBLIC HEALTH

The new Alcohol, Drug Abuse and Mental Health block grant emphasizes planning, establishing, maintaining, coordinating, and evaluating projects for prevention, treatment, and rehabilitation programs and activities dealing with alcohol and drug abuse. The following programs are now consolidated in this block grant:

- Alcoholism Services Demonstration Project
- Substance Abuse Plan
- State-wide grant for Drug Abuse Treatment Service
- NMU Prevention

- "P.A. 339 program," services for incapacitated persons
- Substance Abuse Prevention
- Occupational Alcoholism
- City of Detroit Health Deparment, Women's Treatment
- National Council on Alcoholism Volunteer Development
- Washtenaw council on Alcoholism

The Office of Substance Abuse Services (OSAS) has estimated 750,000 Michigan residents are experiencing severe physical, psychological and social problems as the result of using alcohol and drugs. These people are not the only ones affected by the misuse of alcohol or drugs. Substance abuse problems can impact upon auto accidents, violent crimes, psychological problems, child and spouse abuse, absenteeism, and various other social problems.

OSAS has also indicated their network consists of over 900 licensed prevention, casefinding and treatment service agencies. Treatment and casefinding services are presently serving over 80,000 Michigan residents annually.

Michigan's resources for Substance Abuse programs are the State alcohol restricted funds; and in FY 1981-82, $18,487,300 general fund monies supported community substance abuse prevention, education and treatment grants, P.A. 339 program, and Substance Abuse Prevention Education (SAPE) contracts.

PRESIDENT'S RECOMMENDATION - DEPARTMENT OF PUBLIC HEALTH

The Alcohol and Drug Abuse and Mental Health Block Grant entails Alcohol Project Grants, Alcohol Formula Grants, Drug Abuse Project Grants, Drug Abuse Formula Grants, and Mental Health Services. The Reconciliation Act authorizes total funding up to:

$491 million - FY 1982
$511 million - FY 1983
$532 million - FY 1984

Actual funding each year will depend on appropriations made by Congress.

There is no state match requirement in the Alcohol, Drug Abuse and Mental Health Block Grant.

The allocations for FY 1982 are based upon funding received in FY 1979-80 for alcoholism and drug abuse programs and the funding received in FY 1980-81 for mental health programs.

Michigan's allotment could be reduced if an Indian tribe or tribal organization requests a portion of Michigan's funding and HHS determines the "members of such tribe or tribal organization would be better served by means of grants made directly" to the tribe or tribal organization by HHS. The percentage of Michigan's allotment to be "reserved" for this special provision is determined by the percentage of Michigan's FY 1980 receipts under categorical alcohol, drug, and mental health programs which went to Indian tribes or tribal organization.

Block grant funds may be used for administration costs, but not more than 10 percent. Also, there is a transferability factor. Michigan is allowed to transfer as much as seven percent of its allocation to other health block grants; a 3 percent transfer is allowed in the first three fiscal quarters and the remaining 4 percent in the last quarter.

Michigan is required to certify compliance with 13 assurances of quality, fairness, and appropriateness of expenditure by annual application. The Legislature is required to conduct hearings beginning with the second year of block operation. Proposed spending plans are to be made available for public comment. Also, post-expenditure reports are to be made available for public inspection each year.

According to HHS, the maintenance of effort provision are as follows:

- In FY 1982, states are required to divide all block grant funds between mental health programs and alcohol/drug abuse programs in the same proportion as in FY 1980. In FY 1983, 95 percent of funds must be divided on that basis; and FY 1984, 85 percent.

- For alcohol/drug abuse projects, at least 35 percent must go to alcohol abuse programs, and at least 30 percent of the total must be spent on prevention programs.

Michigan is required to have an independent audit on an annual basis. Also, HHS will conduct reviews in several states each year to insure proper use of funds.

Michigan was allowed to take over administration on October 1, 1981. In order to receive funds beyond FY 1982, Michigan must assume administrative responsibilities by October 1, 1982. If Michigan does not comply with all pre-allotment procedural requirements and receive this block grant funds by October 1, 1982, then the use of these funds may be refrained.

The Administration appropriations request for FY 1982 is $432.1 million. HHS has indicated Michigan's allotment to be $13,095,000 in FY 1982. The Department of Mental Health has indicated their portion to be 28.47% or $3,728,146. Therefore, OSAS could expect $9,366,854 for Alcohol/Drug Abuse Programs.

SFA ANALYSIS OF IMPACT ON STATE OF MICHIGAN

In 1980-81, the programs now consolidated into the Alcohol, Drug Abuse and Mental Health block grant award amounts to state government were $12,573,002 and local government accounted for $426,363. The MDPH appropriation in FY 1981-82 for Substance Abuse programs is $13,856,300. Based on allocation HHS has indicated for OSAS ($9,366,854), Substance Abuse programs in Michigan could experience an estimated federal shortfall of ($4.5) million.

As of January, 1982, the following represents the unemployment rate in Michigan (in thousands of persons):

	Year Ago	Month Ago	Latest Month	% Change Year Ago	% Change Month Ago
Number Unemployed	568	549	656	15.49%	19.49%

Michigan's unemployment rate is a major factor in determining Michigan's economic performance.

Due to the bleakness of Michigan's economy, the OSAS case load is expected to increase as the unemployment rate increases. OSAS has already experienced a 12% admissions increase from 76,262 persons in 1979 to 85,270 persons in FY 1980. In the current fiscal year clients treated are expected to increase from 85,000 to 97,000, a 14% increase.

In order to continue OSAS programs at the current funding level, new legislation could be enacted in order to increase taxes on the sale of alcoholic beverages, and amend the constitution for a new tax on prescription drugs. Legislation could also be enacted to increase drunk driving fines and earmark these fines for substance abuse programs.

SFA/VS/jb
2/17/82-ALCOHOL
REVISED: 2/23/82

SENATE FISCAL AGENCY FEDERAL BUDGET ANALYSIS

MATERNAL AND CHILD HEALTH BLOCK GRANT*
(dollars in millions)

FINANCIAL OVERVIEW

	FY 1980 ACTUAL	FY 1981 ACTUAL	EST. FY 1982 ENACTED	FY 1983 RECOMMENDATION	CHANGE FY 1982 TO 1983	
					DOLLAR	PERCENT
National Total:						
Budget Authority	---	---	$1,390.0	$1,000.0	$(390.0)	(28.1%)
Budget Outlays	$1,148.2	$1,384.0	1,281.0	1,000.0	(281.0)	(21.9%)
State of Michigan						
Est. Allocations	$ 42.2	$ 45.5	$ 47.9	$ 37.4	(10.5)	(21.9%)

PROGRAM DESCRIPTION

The purpose of the Services for Women, Infants and Children Block Grant (previously the Maternal and Child Health Block Grant) within the Department of Health Services Administration is as follows:

- Provide funds to states in order to assure mothers and children access to quality maternal and child health services (in particular, for low-income persons).
- Reduce infant mortality and the incidence of preventable disease and handicapping conditions among children.
- To appropriately immunize children, especially preschool children, against childhood disease.

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*These figures include the Women, Infants and Children program budget outlays. The Department of Health Services Administration has designated payments under the Services for Women, Infants and Children Block Grant program (previously authorized under the Maternal and Child Health Block Grant and the Women, Infants and Children programs).

- To reach more low-income children in need of health assessments and follow-up diagnostic and treatment services.

- Provide preventive and primary care services for low-income children, prenatal, deliverly, and postpartum care for low-income mothers in order to promote better health.

- Provide rehabilitation services for blind and disabled children under 16 who receive benefits from the Social Security Act.

- Provide funds to states in order to assure mother's and children health/nutrition services.

- Provide medical, surgical, corrective, facilities for diagnosis, hospitalization, and aftercare for crippled children or children suffering from conditions which may develop to crippling.

The following programs have been consolidated into this block grant:

- MCH Formula
- Crippled Children Formula
- SSI Disabled Children
- Improved Pregnancy Outcomes
- Early Childhood Appraisal Center
- Pediatric Metabolic Disease Center
- Area Child Amputee Center
- Lead Poisoning
- Sudden Infant Death Syndrome
- Maternal and Child Health Training
- Hemophilia
- Women's, Infants, and Children Program (WIC)

These programs impact and reflect upon the unserved/underserved populations in Michigan. Areas emphasized are maternal, child, and infant health care; the care of young children with handicaps; and nutrition assessments.

In FY 1981-82, $13.0 million of general fund monies helped to support programs within Personal Health Administration and Support Services, Crippled Children Services, and Maternal and Child Health.

PRESIDENT'S RECOMMENDATION

Originally, the national allocation for this block grant was $347.5 million. However, the WIC program has now been consolidated and the Block Grant authorized as the Services for Women, Infants and Children Block Grant program makes $1.0 billion available for payments in FY 1983. Actual funding each year will depend upon appropriations set by the Congress.

The distribution formula is the ratio of Michigan's receipts in FY 1981 of the consolidated programs to all expenditures made by states in FY 1981. If the states appropriation level in FY 1983 is a larger sum than any Federal fiscal year, the increase over FY 1983 is allotted to the states on the basis of the percentage of children in the State below the "official" poverty line compared to the total numbr of children below the poverty line nationally. In FY 1982, 15 percent has been set aside for HHS and 10 to 15 percent in following years for research, demonstration and training projects of national or regional significance; also included is funding of hemophilia centers and genetic disease counseling and screening projects. Michigan must match every four Federal block grant dollars with three State dollars.

Under this grant, Indian tribes cannot apply for direct funding from HHS. Therefore, a state's allotment of funds under this block grant cannot be reduced because of requests made by Indian tribes for funding.

Funds allocated in this block grant cannot be transferred to other block grants.

The reporting system requires MDPH to submit a report to HHS Secretary which describes their intended use of funds and a description of their compliance with eight assurances of quality, fairness and appropriateness of expenditures. This report must be available for public comment. Also, MDPH must prepare annual post-expenditure reports on how funding was used with the opportunity for public inspection.

An independent audit of Michigan's program is required for every other year.

SFA ANALYSIS OF IMPACT ON STATE OF MICHIGAN

HHS has indicated $46,138,099 (includes the Women's, Infants, and Children Program) FY 1982 to be allocated to Michigan. The MDPH appropriation in FY 1981-82 for these consolidated programs is $48,512,800. Michigan could experience an estimated federal shortfall of ($2.4 million) in regards to this block grant.

Presently, there exists the assumption that the federal funding level for FY 1982 is relatively sound. However, further cuts could occur after the March expiration date of the Continuing Resolution.

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2/17/82-MATERNAL
REVISED: 2/23/82

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SENATE FISCAL AGENCY FEDERAL BUDGET ANALYSIS

MEDICAID (TITLE XIX)
(dollars in millions)

FINANCIAL OVERVIEW

	FY 1980 ACTUAL	FY 1981 ACTUAL	EST. FY 1982 ENACTED	FY 1983 RECOMMENDATION	CHANGE FY 1982 TO 1983 DOLLAR	CHANGE FY 1982 TO 1983 PERCENT
National Total:						
Budget Authority	$14,445	$17,442	$18,945	$12,925	$(6,020)	(32.0%)
Budget Outlays	1,441.0	16,843	18,101	17,006	(1,095)	(6.0%)
State of Michigan						
Est. Allocation*	$ 621.3	$ 703.6	$ 780.9	$ 731.2	$ (47.1)	(6.0%)
% of Total Program Federally Funded	50%	50%	49%	47%		

PROGRAM DESCRIPTION

Title XIX of the Social Security Act (1966) authorizes federal monies for medical services to certain low income recipients. There is a variable federal matching formula inversely related to a state's per capita income that ranges from a high of 83% and a low of 50%. Michigan's rate of federal financial participation for Medicaid has been 50%.

Services delivered under Title XIX include seven mandatory components as well as other optional services. While Title XIX in most cases refers to medical services, there are other related programs and administrative functions within the DSS, DPH and DMH budget that are supported with these monies.

At the present time, there are approximately one million Medicaid eligibles receiving such benefits in Michigan. In the main, the largest amount of dollars is expended for older clients in hospitals or institutional settings.

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* Preliminary estimates, pending further analysis and clarification of administration's recommendations.

PRESIDENT'S RECOMMENDATIONS

I. Base Perspective

In order to begin to understand the impact of the Executive 1983 budget proposals for Title XIX, it may be helpful to view the Michigan Medicaid program as it currently exists in FY 1982.

• Cost containment included in P.A. 35	$ (50.3) GROSS	$ (27.1) GF/GP
• Cost containment included in E.O. 1981-9	(42.4)	(21.2)
Projected supplemental need includes:	230.0	120.0

- anticipated 1 - 2% loss in federal match
- assume savings from AFDC eligibility changes
- return to accrual accounting system
- recognize FY 1981 53rd payroll

What this brief summary demonstrates is that despite Michigan taking full advantage of many of the cost containment initiatives introduced/authorized per the Omnibus Reconciliation Act, as well as earlier years, the program faces a serious deficit in the current fiscal year. Looking toward total assumption of the program in FY 1984, the President proposes a number of additional cost containment aimed at improving efficiency and management.

II. 1983 Proposed Changes

1. Assume continuation of FY 1982 federal policy/reimbursement changes into FY 1983.

Michigan Impact

The Governor's FY 1983 budget reflects an anticipated loss of 3% federal matching dollars resulting in a new cost to the state of $19.6 million. The net effect of this loss is that all other service reductions/changes in FFP must be added on top of this 3% reduction. Continuation of the cost containment "flexibility provisions" initiated in FY 1982 may result in some savings in hospital expenditures, but short of elimination of services would have minimal effect on the smaller accounts.

2. Reduce federal matching for optional services by 3%. Effective date: July 1, 1982.

Michigan Impact

Michigan, along with more than 30 other states provides services to the "medically needy." This group of clients is made up primarily of older recipients. A 3% reduction would affect this population along with those clients who require pharmaceutical services, basic nursing home services, and many other "preventative" supportive medical services. In dollars the cut represents approximately a $26 million reduction. It would mean the total elimination of many of these services.

3. Require imposition of beneficiary co-payments. Effective date: October 1, 1982

Michigan Impact

Currently, the Michigan program has instituted co-payments already on dental, vision, podiatric, chiropractic, pharmacy and hearing aid services. Nationally, savings of $329 million are projected for FY 1983. Studies have shown, Hopkins and Roemer (1975), that when co-payments are imposed the sickest patients suffer the greatest financial burden and may delay treatment until the condition is life threatening and require much more expensive care. There are no indications that the President accounted for the additional administrative costs or higher cost offsets associated with copay requirements. It is difficult to predict if any savings could be realistically expected with this policy.

4. Assumption of long-term care costs by relatives. Effective date: July 1, 1982

Michigan Impact

This policy change would require amendments in Michigan state statutes. While the President estimates savings at $238 million nationally, without understanding more about the voluntary versus mandatory relative requirements, it is not possible to project savings for Michigan. In recent years, bills have been introduced without enough support for passage relating to probating of estates and divestment. Current year appropriations included $6.6 million gross for savings due to enactment of divestment legislation.

5. Eliminate federal matching for state Medicare buy-in. Effective date: July 1, 1982

Michigan Impact

In the past states have been encouraged to "buy in" for Medicare recipients with a 50% federal match. Should the FFP be disallowed, Michigan would be faced with assuming costs of aproximately $5 million or deciding to discontinue the "buy-in" benefit which would most likely result in an increase in total Medicaid expenditures as those Medicare recipients shift over as Medicaid eligibles.

6. Eliminate special federal matching rates. Effective date: July 1, 1982

Michigan Impact

This elimination of special rates would affect programs such as family planning, certain administrative services and the Medicaid Management Information System. In the Department of Public Health other specific functions such as nursing home inspections would receive reduced FFP. Fiscal year 1983 savings nationally are projected at $64 milion. Michigan's loss could approximate $3 - $5 million.

7. State responsibility for erroneous payments. Effective date: October 1, 1982

Michigan Impact

The object of this proposal is to have a zero based error rate by 1987. (It would appear that this policy was conceptualized prior to the 1984 federal take-over of Medicaid--at which time presumably the federal government would be responsible for paying for errors. National savings are estimated for FY 1983 at $59 million.

8. Institute combined Welfare Administration.

Michigan Impact

The President proposes to combine the administration of AFDC, Food Stamps and Medicaid at 95% of the current federal funding with no state matching requirements. Besides the loss in FFP to Michigan, it is difficult to imagine any consolidation of these three diverse and large Michigan program administrations. Again, this idea would not work under the New Federalism proposed for FY 1984. National savings in FY 1983 are estimated at $218 million.

9. Shorten Medicaid extension to ineligible AFDC clients. Effective date: July 1, 1982

Michigan Impact

This change would reduce the extended time of Medicaid eligibility from four months to one month. Repercussions of this policy would shift the responsibility for caring for a sick ineligible recipient to the county/local level. Savings nationally are estimated at $75 million.

10. AFDC Changes

Michigan Impact

Policy changes aimed at reducing AFDC eligibility through increased work requirements and administrative adjustments assume national savings in Medicaid of $153 million for FY 1983. Depending upon the validity of these assumptions, Michigan's savings could range from -0- to $6 million.

11. SSI Changes

Michigan Impact

Policy changes aimed at re-defining disability could have the impact of disqualifying many SSI recipients currently receiving Medicaid services. Nationally the expectation is for $176 million savings in FY 1983. Michigan Medicaid could recognize appreciable savings if a large number of disabled were no longer eligible in FY 1983. If you assume a drop of 10,000 recipients you may anticipate up to $20 million gross savings. However, if one considers that the General Assistance Medical Program would more than likely assume the responsibility for these discarded and probably chronically ill clients, then it is clear there would not only be no savings but state costs would increase.

12. Medicare Changes

Michigan Impact

There are many program changes recommended for Medicare that would have a direct or sometimes less than a direct bearing on expenditures in the Medicaid program. Tightening of medicare eligibility requirements, institution of home health service copayments, reductions in hospital and physician reimbursement all result in costs passed on to Medicare recipients. Considering that these recipients have Social Security checks from which they make up the difference, an earlier dependence than might have been expected upon Medicaid is not unlikely. Nationally, total savings approach $1.75 billion.

III. FY 1984 The New Federalism

The President has already made recommendations regarding FY 1984 and three years beyond. The proposal would transfer Title XIX to the federal government in exchange for the states assuming responsibility for the AFDC and Food Stamp programs.

The rationale suggested for the shift is that the federal government assumes that through a central administration the rapidly rising Medicare and Medicaid costs can be brought in line.

The consequences for Michigan Medicaid recipients would appear to be a reduction in benefit levels. As a result of federal assumption, it would not be unrealistic to expect that with more liberal benefit packages states like Michigan would not continue to offer their recipients optional services. This would for the most part affect the medically needy elderly--many of whom reside in nursing homes. Another possible consequence of the reduction/elimination of optional services is greater costs--i.e., a recipient who cannot afford to purchase drugs could easily end up hospitalized.

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SENATE FISCAL AGENCY FEDERAL BUDGET ANALYSIS

PREVENTIVE HEALTH AND HEALTH SERVICES BLOCK GRANT
(dollars in millions)

FINANCIAL OVERVIEW

	FY 1980 ACTUAL	FY 1981 ACTUAL	EST. FY 1982 ENACTED	FY 1983 RECOMMENDATION	CHANGE FY 1982 TO 1983 DOLLAR	CHANGE FY 1982 TO 1983 PERCENT
National Total:						
Budget Authority	--	--	$ 95.0	$ 83.0	$(12.0)	$(12.6%)
Budget Outlays	$ 82.8	$ 99.3	81.6	81.6	--	--
State of Michigan Est. Allocation	6.5	4.4	3.4	3.4	--	--

PROGRAM DESCRIPTION

The Preventive Health and Health Services Block Grant is administered by Preventive Health Services within the Centers for Disease Control Department. Its purpose is to provide the state with funds for individuals and families, especially those of limited means, and for a variety of public health services to reduce preventable morbidity and mortality and improve quality of life. Eight categorical grant programs were consolidated into this block grant. They are as follows:

- Emergency Medical Services
- Health Incentive Grants (comprehensive public health services)
- Hypertension Control
- Rodent Control
- Fluoridation
- Health Education/Risk Reduction
- Home Health Services
- Rape Prevention and Crisis Services

Federal support has been present since 1975 for many of these programs. Emergency Medical Services, Hypertension Control, and Health Education/Risk Reduction received $1,242,600 in general fund monies for FY 1981-82 (Act 47 of P. A. 1981).

PRESIDENT'S RECOMMENDATION

The authorized funding level for this block grant is as follows:

- $95.0 million in FY 1982
- $96.5 million in FY 1983
- $98.5 million in FY 1984

The actual funding level to the states for each year depends on appropriations made by Congress.

The Continuing Appropriations Resolution, P.L. 97-72 (H.R. 370) was signed by President Reagan and provides funding from December 15, 1981, to March 31, 1982. If an appropriation bill is enacted, it will supersede the provisions of the Continuing Resolution. The following figures represent the Preventive Health Services funding on the National level.

	FY 1981 Funding Level	Continuing Resolution Level (Vetoed 11/23)	Continuing Resolution 12/15 - 3/31/82	% Continuing Resolution 12/15 - 3/31/82 Below FY 1981
Preventive Health Services	99.3	83.3	81.6	(18%)

In FY 1980-81, Michigan received $4,025,218 and the local award amount was $403,256 for categorical programs now consolidated into this block grant. The Health and Human Service Department (HHS) has specified $3,341,600 to Michigan during the period of the Continuing Resolution for the Preventive Health and Health Services Block Grant. This funding level represents a (24.5%) reduction below the award amounts received in FY 1981.

Michigan can transfer up to 7 percent of this block grant's (except for rape prevention) allocation to other health block grants. The first three fiscal quarters are allowed to transfer up to 3 percent and the remainder will be in the last quarter.

The Rape Prevention and Crisis Services is a special provision to the Health Prevention Services Block Grant. Three million dollars is authorized for each fiscal year for this program and shall be allocated according to Michigan's population (Sec. 1901(b) and 1902(b) and 19404(a)(2)). The minimunm amount a State can receive is $60,000 and the maximum amount is $150,000.

As part of the maintenance effort, the State must provide grants for hypertension programs at 75 percent of FY 1981 funding in its FY 1982 program; 70 percent in FY 1983; and 60 percent in FY 1984.

Another special provision is no more than 10 percent of the block grant funds can be used for State administration costs. The State is also required to conduct legislative hearings beginning with the second year of block operation. Proposed spending plans are to be made available for public comment and post-expenditure reports are required each year for public inspection.

State programs are required to have independent audits. HHS will conduct reviews each year to insure proper use of funds.

There are no matching requirements, for these block grant funds must supplement State or Local funding and may not supply a substitute for such spending.

SFA ANALYSIS OF IMPACT ON STATE OF MICHIGAN

Act 47 of P. A. 1981 is the appropriations act for the Michigan Department of Public Health (MDPH) for the fiscal year ending September 30, 1982. The FY 1981-82 MDPH appropriation for the categorical programs now consolidated in the Preventive Health and Health Services Block Grant is $10,374,100. According to the Health and Human Services Department (HHS), Michigan will receive $3,341,600 in FY 1982. Based on the FY 1981-82 MDPH appropriation, this new funding level is approximately $7.0 million below the current funding level. Such a reduction of federal funds will effect certain sections of Act No. 368 Public Acts of 1978, the Public Health Code.

Due to the constraints of the State budget, the Emergency Medical Services program has experienced set-backs for further program implementation. The additional federal reduction may result in noncompliance with sections of the Public Health Code concerning the licensing/certification and training/education of emergency medical technicians (Part 203, Section 20335(s) of Act 368, P.A. 1978).

There are no provisions in the Continuing Resolution for Health Incentive Grants (comprehensive public health services - PHS 314(d)). MDPH has received PHS 314(d) funds for over ten years. These funds have been used to implement the State/local cost sharing program. These funds have been redistributed in Michigan to local health departments in order to respond to health problems occurring in their area. In FY 1981-82, the State/local cost sharing program was funded at $16,334,500. PHS 314(d) funds accounted for $1,377,300 of this program's funding. The total appropriation for PHS 314(d) funds in FY 1981-82 is $2,754,500.

The loss of PHS 314(d) funds will impact upon the State/local cost sharing program already experiencing great difficulties in meeting the 50 percent funding level as specified by section 2475(a) of Act 368, P.A. 1978. Legislation has been introduced, S.B. 337, as a resource for the State/local cost sharing program. S.B. 337 proposes to increase the cigarette tax by 2-1/2 mills; 1-1/2 mills is earmarked for the State/local cost sharing program. An additional $36 million would be generated for cost sharing upon the passage of S.B. 337.

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SENATE FISCAL AGENCY FEDERAL BUDGET ANALYSIS

PRIMARY CARE BLOCK GRANT
(dollars in million)

FINANCIAL OVERVIEW

	FY 1980 ACTUAL	FY 1981 ACTUAL	EST. FY 1982 ENACTED	FY 1983 RECOMMENDATION	CHANGE FY 1982 TO 1983 DOLLAR	CHANGE FY 1982 TO 1983 PERCENT
Michigan Total:						
Budget Authority	---	---	$ 414.8	$ 417.0	$ 2.2	0.5%
Budget Outlays	$ 514.8	$ 578.1	414.5*	416.8	2.3	0.5%
State of Michigan Est. allocation	$ 15.7	$ 17.6	$ 12.6	$ 12.7	$ .1	0.8%

PROGRAM DESCRIPTION

Primary health services are to be provided to medically underserved populations through primary care. According to the U.S. Department of Health and Human Services (HHS), the following statements represent the major purposes of the block grant:

- providing grants to public and to private non-profit entities for planning, development and operation of community health centers;
- supporting and delivery of family-oriented health services in medically underserved areas, both rural and urban, through centers;
- emphasizing services to low-income persons, especially children and the elderly;

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*Reflects the administration's expansion to include categorical programs for black lungs clinics, primary care research and demonstration, migrant health, family planning, and primary health care centers.

- providing for ties between primary care centers and secondary (specialty and inpatient) and tertiary (medical centers) providers.

Community Health Centers and Primary Care Research and Demonstrations are the consolidated programs for this block grant. Although these programs are within the Primary Care Block grant, they are essentially categoricals.

According to MDPH, seventeen percent of Michigan's population resides in areas designated as medically underserved (MUA), and 84,448 persons were ministered to by Michigan Community Health Centers in 1981.

PRESIDENT'S RECOMMENDATION

There are special provisions for funding which say the FY 1983 distribution of funds to the State are to be base dproportionally on funds received in FY 1982 for community health centers. An amount of a State's allocation for Indian tribes or tribal organizations can be made available by HHS. Funds from this block grant are not to be transferred to other block grants. Also, no Federal funds can be used for State administration costs.

HHS specifies the reporting procedure shall be as follows:

- In a required annual application, each State must certify compliance with eight assurances of quality, fairness, and appropriateness of expenditure. State Legislature hearings are required beginning with the second year of block operation. The states will prepare proposed spending plans and make them available for public comment.
- Post-expenditure reports, available for public inspection, are also required each year.

The maintenance of effort stipulates in FY 1983, funding of existing centers must be proportionate to funding received in FY 1981. Also, HHS must approve any defunding of centers by the states.

An annual independent audit of state programs is required. HHS conducts reviews each year to assure proper use of funds.

There is a matching requirement; 20 percent matching is required by the State for FY 1983, and 33 percent is required in FY 1984. HHS will continue to manage the primary care programs through FY 1982. If a State doesn't elect to receive the Primary Care Block, HHS will fund the centers directly. In FY 1982, $2.5 million is available to states to conduct planning for administration of this block grant.

SFA ANALYSIS OF IMPACT ON STATE OF MICHIGAN

The administration intends to include certain categorical programs into the Primary Care Block Grant beginning in 1983. The following figures represent the national estimated allocation for these programs in FY 1982:

Primary Care Centers	1982 Estimates
- Primary care block grant	$ 246,337,000
- Primary care research & demonstration	1,901,000
- Black lung clinics	3,240,000
- Migrant health	38,051,000
- Family planning	123,658,000
Subtotal Direct Program	$ 413,187,000
- Primary health care center	$ 1,191,000
- Migrant health	98,000
- Family planning	25,000
Subtotal Reimbursable Program	$ 1,314,000
TOTAL BUDGET OUTLAY	$ 414,501,000

Assuming a percentage share for Michigan at .0303, the estimated allocation in FY 1982 is $12.6 million. This represents a ($5.0) million reduction from the FY 1981 allocation of $17.6 million.

Primary care is essential to Michigan in order to help combat the increasing costs of health care.

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FUNCTION 600

INCOME SECURITY

SENATE FISCAL AGENCY FEDERAL BUDGET ANALYSIS

AID TO FAMILIES WITH DEPENDENT CHILDREN
(AFDC) TITLE IVa
(dollars in millions)

FINANCIAL OVERVIEW

	FY 1980 ACTUAL	FY 1981 ACTUAL	EST. FY 1982 ALLOCATION	FY 1983 RECOMMENDATION*	CHANGE FY 1982 TO 1983*	
					DOLLAR	PERCENT
National Total:						
Budget Authority	$ 7,709	$ 8,036	$ 5,893	$ 5,454	$ (439)	(7.5)%
Budget Outlays	7,308	8,064	7,811	5,454	(2,357)	(30.2)%
State of Michigan:						
Est. Allocation	567.3	584.9	561	459	(102)	(18)%

PROGRAM DESCRIPTION

Aid to Families With Dependent Children (AFDC) is a financial assistance program authorized under Title IVa of the Federal Social Security Act and is designed to provide monetary help to children who are deprived of parental support or care. This program is funded in Michigan with 50% Federal and 50% State dollars.

The AFDC program is an entitlement program administered by the Department of Health and Human Services, Office of Family Assistance.

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* Preliminary estimate; no cost offsets included.

PRESIDENT'S RECOMMENDATION AND SENATE FISCAL AGENCY ANALYSIS OF IMPACT ON MICHIGAN

	Fiscal Impacts (in millions) National est.	State
1. Require States to have Community Work Experience Programs Effective date: July 1, 1982 Currently, states are permitted to have workfare programs for AFDC recipients, where the adult recipient "works off' his or her grant in either job sites or training. The new policy would require states to provide this program to all its AFDC recipients and AFDC-U recipients would be required to participate. No additional federal funds are allocated for administration of this program. The following is an estimate of minimum and maximum costs:	$ (49)	$9.1 to $60.4 (additional cost to implement the program)

Minimum estimate

To serve 40,000 AFDC-U cases:

Staffing costs - @ 150 cases/FTE:	$ 5,600,000
Transportation (minimum) $25/month:	12,000,000
	$ 17,600,000
Sanctioning* - 5% of cases:	(8,460,000)
Total Net Costs	$ 9,140,000

Maximum estimate

To serve 230,000 cases:

Staffing	$ 32,200,000
Transportation	69,000,000
	$101,200,000
Sanctioning - 5% of cases 9 mos.	(40,779,000)
Total Net Costs	$ 60,421,000

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*Savings based upon an estimate of cases which would close due to non-compliance with work requirements.

At present, the state has work relief slots to accommodate 12,000 GA cases per month. Given the time constraints and lack of funding, it would appear impossible to develop enough workfare public sector sites in order to serve the entire AFDC population. It is also doubtful enough public service slots could be developed in such a short period of time. If current GA work relief sites are used for AFDC-U recipients, our savings in GA due to sanctioning will decline.

If the Department chooses to actually provide slots for a percentage of AFDC-U recipients, cost estimates would be reduced proportionately.

	Fiscal Impacts (in millions)	
	National est.	State
2. Provide AFDC to unemployed parents in intact families (AFDC-U) only if parent participates in workfare. Effective date: July 1, 1982.	$(86)	-0-

Because workfare sites will be inadequate to serve the 40,000 cases on AFDC-U, it would seem unfair to sanction these cases for lack of participation in programs which are unavailable to them. If the regulations state that cases will only be sanctioned for refusal to register for workfare, then no savings will result since it will merely replace the current WIN registration requirement with a new one. Additionally, once cut off from AFDC-U, a parent may show up on the GA caseload, costing the state additional money.

The President's budget recommendation may be double-counting savings in this recommendation and no. 1 above. Savings estimates for Michigan as outlined above would be $8.4 million, but costs would be more than double the savings.

3. Mandate job search for all AFDC applicants. Effective date: July 1, 1982.	$(145)	-0-

Job search requirements for applicants have been implemented on a pilot basis in Michigan in Kent County. Although 65% either withdrew their application or were ineligible prior to eligibility determination, an estimated 50% would have dropped off anyway. The net effect of job search requirements for applicants is still unknown. In times of high unemployment, no savings can be anticipated because it will be easy for an applicant to prove that he/she could not find a job.

4. Remove parent/caretaker from the assistance unit for voluntarily quitting work, refusing employment or a workfare assignment. Effective date: October 1, 1982.	Unknown	Negligible savings

This policy appears to address the current work disincentives built into the changed income disregard and day care deductions policies. If AFDC recipients find that their work-related expenses, such as day care, make it impossible for them to meet their rental and other obligations, quitting work may be the most reasonable alternative. The new policy would sanction the client for quitting work when expenses for work approach or exceed earnings. Good cause provisions for quitting work such as for sexual harassment, unhealthy work conditions, or work expenses in excess of earnings will need to be addressed in regulations.

	Fiscal Impacts (in millions) National est.	State
5. Eliminate funding for the Work Incentives (WIN) program	$(245)	$(15)
6. End employable parent's benefit when youngest child reaches 16.	$ (74)	$ -0-
7. Prorate shelter and utilities for AFDC families in large households.	$(174)	$ 5

5. Eliminate funding for the Work Incentives (WIN) program

Effective date: October 1, 1982.

This year the WIN program has been severely curtailed. Total elimination will reduce services to 101,000 cases. The WIN program provided services to approximately 60,000 in FY 1980-81. Of these 60,000, only 4,600 closings due to employment could be attributed to WIN. Elimination of these services with no replacement funding will place the burden of employment and training services on the state and local levels of government. The WIN program had already been reduced this year from $30 million to $15 million.

6. End employable parent's benefit when youngest child reaches 16.

Effective date: July 1, 1982

Ending AFDC benefits for what will probably be displaced homemakers who have been out of the job market for several years will likely result in an earlier shift of these cases to General Assistance. Without training or employment services, it is unlikely that all those recipients will be able to compete successfully in the private job market. Increased state costs resulting from a shift of these cases to GA, will probably offset any savings due to this policy change.

7. Prorate shelter and utilities for AFDC families in large households.

Effective date: July 1, 1982

Michigan currently prorates shelter and utilities by AFDC case. However, if two households live together, for each family eligible for AFDC, the shelter and utilities maximum may be obtained as long as the grants do not exeed actual expenses. Prorating the maximum for cases sharing living expenses will encourage more independent living situations, likely resulting in increased rather than decreased costs as households breakup. Additionally, administrative expenses will increase in order to determine total household information.

	Fiscal Impacts (in millions) National est.	State
8. Require states to count federal or state energy assistance payment as income for AFDC. Effective date: July 1, 1982	$(175)	$(17)
9. Include the income of all unrelated adults as part of the AFDC assistance unit for purposes of computing benefits. Effective date: July 1, 1982	$ (69)	Savings not determinable.
10. Include all minor children in the AFDC unit, except for disabled children who have separate benefits. Effective date: July 1, 1982	$ (63)	Savings not determinable.

8. Require states to count federal or state energy assistance payment as income for AFDC. Effective date: July 1, 1982

Although this policy is intended to "reduce program overlap," the utility portion of grants is inadequate to meet heating costs. The LIEAP money is intended to supplement the AFDC grants. Currently, the average heating bill for the 43,000 AFDC households on the voluntary heating fuel plan is $1,255 per year, whereas the average AFDC grant covers only $732 leaving a deficit of $523 per year. Heating costs for AFDC recipients are often higher than the general population because homes lack insulation and families opting for VHF have more square footage than the average case. In spite of this, most cases have heating costs in excess of the average of the general population due to poorly insulated homes. As clients find that they cannot meet expenses with the reduced grants, they will apply for emergency needs program payments. These will be considered income and will result in more case closings. The net result of this policy change will be increased vendored heat cost settlements for those in the VHF plan (currently we are spending over $31 million in excess costs), increased ENP expenditures for heating emergencies, and closing of cases due to ENP being counted as income. Loss of funds to the state is estimated at $9 million gross, $4.5 million GF/GP in grant reductions and/or closures of 60,000 cases. Another $18 million savings, if ENP payments in the consolidated energy program are considered income, would result from closure of the majority of another 50,000 cases.

9. Include the income of all unrelated adults as part of the AFDC assistance unit for purposes of computing benefits. Effective date: July 1, 1982

This policy assumes that all the income of an unrelated adult in an AFDC household is available to the unit. This assumption is liable to be challenged in court. One cannot assume that boarders make their income available to the rest of the household, particularly if they are only renting. How this will affect specific AFDC households will depend upon federal regulations. Some savings will likely result due to inclusion of other income in living together arrangements. Some households are likely to split up with no effect upon grant levels.

10. Include all minor children in the AFDC unit, except for disabled children who have separate benefits. Effective date: July 1, 1982

Minor children who have significant separate resources can be currently excluded at the option of the AFDC family.

		Fiscal Impacts (in millions) National est.	State
11.	Eliminate military service by the father as a reason for AFDC eligibility. Effective date: July 1, 1982 Under current policy, a family who still receives support from the absent parent who is in the military, may be eligible for AFDC. The changed policy would prohibit this. Families without support would still be eligible and greater effort would be made to collect support payments through the military.	$ (16)	$ (1.2)
12.	Require states to round benefits to the lower whole dollar. Effective date: July 1, 1982. This policy will reduce benefits and make all AFDC transactions in whole dollars. Michigan alredy does this.	$ (10)	$ -0-
13.	Prorate first month's benefit based upon the date of application. Effective date: July 1, 1982 Currently, benefits are paid from the first pay period after eligibility is determined. Proration of benefits to the date of application will cost Michgian since we now pay up to thirty days after application is made. Proration may increase administrative errors and mispayments.	$ (14)	$ 4
14.	Eliminate optional AFDC emergency assistance program and broaden the LIEAP program to include emergency assistance type expenditures. Effective date: October 1, 1982. At the same time the emergency assistance federal funding is being eliminated, the broadened LIEAP program is being cut from $1,732 million for FY 1982 to $1,300 million for FY 1983. The federal matching funds for emergencies will be reduced at the state level.	$ (60)	$(27)
15.	Phase-in full responsibility to the states for erroneous payments in AFDC, Medicaid, and Food Stamps. Effective date: October 1, 1982 A zero error tolerance would be phased in for 1986. A 3% error rate would be tolerated in 1983, with mispayments along that rate being absorbed by the state. Currently, the AFDC mispayment rate stands at 7% down from 8.4% during 1979-80. Error rates will always exist but dollar-for-dollar reductions will be made as of 1986. In 1983, federal fiscal	$(234)	$ 22.8

sanctions would be $22.8 million based upon the current rate. Further, this recommendation will need to be looked at again if the New Federalism proposals are adopted. It would appear that states would take responsibility for errors along with 100% program funding and that the federal government sanctioning states for a program outside its jurisdiction may not be workable.

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SENATE FISCAL AGENCY FEDERAL BUDGET ANALYSIS

CHILD SUPPORT ENFORCEMENT
(dollars in millions)

FINANCIAL OVERVIEW

	FY 1980 ACTUAL	FY 1981 ACTUAL	FY 1982 ENACTED*	FY 1983 RECOMMENDATION	CHANGE FY 1982 TO 1983 DOLLAR	CHANGE FY 1982 TO 1983 PERCENT
National Total:						
Budget Authority	$	$ 448	$ 409	$ 408	$ (1)	(.2)
Budget Outlays	388.7	421.5	455.5	387.4	(68.1)	(15.0)
State of Michigan Est. Allocation	27.4*	30.4*	34.5*	29.3	(5.2)	(15.0)

PROGRAM DESCRIPTION

The Office of Child Support Enforcement, Office of the Secretary, Department of Health and Human Services allocates grants to assist in the enforcement of child support obligations owed by parents. This program exists under the authority of Title IV-D of the Social Security Act, effective 8/1/75.

The State of Michigan, through the Department of Social Services, Office of Child Support, provides child support enforcement services to individuals receiving Aid to Families with Dependent Children (AFDC), and to applicants who are not eligible for AFDC. Individuals on AFDC assign child support rights to the State of Michigan. Child Support Enforcement (CSE) services include services to; locate absent parents, establish paternity and enforce support obligations. At the present time, the federal government pays 75% of state and local administrative costs for Child Support Enforcement agencies (including court personnel who deal in child support services regularly). Fifteen percent (15%) of the federal portion (1/2) of AFDC child support collections are allocated to the counties for incentive payments. During FY 1980-81, Michigan's AFDC incentive payments totaled $13.5 million.

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*Based on 75% match for administrative costs and 15% of federal portion of AFDC collections (incentive fee).

PRESIDENT'S RECOMMENDATION

The President's recommendation is intended to provide incentives for improving state and local cost-effective performance by restructuring federal matching. The current structure would be repealed. In its place, the federal share of administrative costs would be based on a formula which would flow-through incentive payments to the state and counties based upon such factors as: total improvement of collections, total collections compared to other states, and administrative costs as a percentage of collections. The formula has not yet been revealed. A minimum 50% federal match would be retained. The 25% on top of that would be funded based upon the formula. The Secretary would have the authority to reevaluate and change the formula every 2 years. This funding proposal has not yet been approved by the Secretary and legislation will be required to implement.

The Administration is also proposing that states retain 6% of child support collections from non-AFDC cases who have applied for IV-D enforcement services, to cover the costs of enforcement. The Administration estimates that this will result in a $45 million savings in administrative costs. The existing fee in non-AFDC ($18 per year in Michigan) would be repealed. Many states require all non-AFDC cases to apply for IV-D enforcement services, so for these states the entire non-AFDC support order collections would be affected.

In order to improve Child Support Enforcement (CSE) identification and collection processes, availability of information for CSE agencies will be increased and allotments against military pay will be made for military personnel who are delinquent in support obligations.

The Administration claims that restructuring the CSE system will increase AFDC collections and decrease the federal share of CSE administrative costs by approximately $150 million in 1983 and close to $900 million over the next five years.

SFA ANALYSIS OF IMPACT ON THE STATE OF MICHIGAN

Under the proposed restructured incentive scale, the State of Michigan (including local units of government) will probably sustain substantial loss of federal funds because we currently have one of the best programs so our amount of improvement will be small compared to other states.

Also, it is feared that many custodial parents will withdraw their applications from the non-AFDC enforcement effort because of the restructuring of the system. This will increase AFDC expenditures. The 6% fee applied to collections on non-AFDC collections will reduce income available for the support of children. Non-AFDC children throughout the United States received $870 million last year under the Child Support Enforcement Program. Under this policy, children would lose millions of dollars of support. With less money available for child support, families with marginal income will more likely shift to AFDC as their support reduction makes them eligible. This will result in increased state costs.

The proposed restructuring of the Child Support Enforcement program could very likely penalize states which already have cost effective programs, such as Michigan's which has been collecting 20-25% of the total amount of support collected in the United States. The formula will reduce federal support of the program and thereby reduce the probability of continued success in the form of increased collections.

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SENATE FISCAL AGENCY FEDERAL BUDGET ANALYSIS

FOOD STAMPS
(dollars in millions)

FINANCIAL OVERVIEW

	FY 1980 ACTUAL	FY 1981 ACTUAL	EST. FY 1982 ALLOCATION	FY 1983 RECOMMENDATION	CHANGE FY 1982 TO 1983 DOLLAR	CHANGE FY 1982 TO 1983 PERCENT
National Total:						
Budget Authority	$ 9,182	$10,556	$10,563*	$ 9,531	$(1,122)	(10.5%)
Budget Outlays	9,117	10,340	10,613	9,563	(1,050)	(9.9%)
State of Michigan Est. Allocation	$ 272.2	412.2	425	279.3	(145.7)	(34%)

PROGRAM DESCRIPTION

The Food Stamp Act of 1977 continued the food stamp entitlement program with several substantive changes. The program is due for reauthorization in 1982. The Omnibus Budget Reconciliation Act of 1981 adds further restrictions which are estimated to eliminate benefits to approximately 4% or 16,000 food stamp households in Michigan. The food stamp program, administered by the U.S. Department of Agriculture (USDA) has two basic objectives:

a. To help maintain a minimum nutritional level for low-income households.

b. To buttress the agricultural industry through increased food purchasing power of the U.S. low-income population.

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* 10-1/2 month funding level; $11.3 billion full year level making total reduction actually 15.7%. Actual expenditure estimates are $11.6 million, or a reduction of 17.6% in outlays.

The food stamps are coupons negotiable in stores for food products at face value and serve to subsidize the low-income household's ability to purchase a minimally nutritious diet. The value of the food stamps is underwritten with 100% Federal funds. However, administration of the program and food stamp issuance costs are 50% Federal, 50% State. Only the administrative costs are appropriated in the State's Department of Social Services Appropriations Act.

Recipients must meet income and other eligibility guidelines before food stamps are issued.

PRESIDENT'S RECOMMENDATION AND SENATE FISCAL AGENCY ANALYSIS

	Fiscal Impact to the State
1. Count federal Low-Income Energy Assistance Payments as income for determination of eligibility and benefit levels. Effective date: July 1, 1982 The $37 per month energy money received during the winter months will be counted as income, as will any home heating tax credit money or emergency heat funding. This will likely impact about 80% of all families receiving LIEAP funds. Northern states will feel the impact of this policy change the most due to their greater need for heating assistance. As emergency needs payments are counted as income, many cases will close.	$(15)
2. Eliminate the 18% earned income disregard when calculating food stamp benefit levels or elgibility. In effect, taxes and F.I.C.A. which the client never sees, would no longer be deductible, reducing substantially the incentive to work. All food stamp cases with reported earnings would be affected. Savings estimate does not include cost offsets for those who quit work. Effective date: July 1, 1982	(20)
3. The benefit reduction rate will be increased from 30% to 35%. Effective date: July 1, 1982 Currently, the maximum benefit a household can receive is reduced by $.30 for every $1 of net income. This policy would raise the rate to $.35 of each dollar. A family with $300 net income now receiving $143 in food stamps would receive $128. Most cases would experience a 10% reduction with a total loss in federal funds of $49 million.	$(49)
4. Reduce federal share for administration to 95% of the 1982 level in th "Combined Welfare Administration. Effective date: October 1, 1982 This, when adjusted by inflation, equates to a 10% reduction. Increase administrative costs for workfare programs and error reduction efforts come at a time when the federal share in the basic administration is being reduced. No administrative costs associated with program changes will be borne by the feds.	$(21.3)

	Fiscal Impact to the State
5. **Require States to pay for errors in excess of 3% in 1983, 2% in 1984, and 1% in 1985, and zero in 1986.** Effective date: October 1, 1982 Our food stamp mispayment rate for FY 1981 was 11.3%. If this rate continues for 1983, Michigan would lose $32.7 million in 1983. Errors will never be totally eliminated and there comes a point when the administrative costs in reducing errors exceeds savings. This policy could be meaningless for 1984, since the states would totally fund and administer the program under the New Federalism proposal.	$(32.7)
6. **Require applicants to participate in job search.** Effective date: October 1, 1982 This policy change is expected to discourage program participation although many food stamp applicants already withdraw their applications for various reasons. This will have no effect in Michigan because unemployment stands at 15%.	-0-
7. **Benefits will be rounded to the lower whole dollar; monthly benefits of under $10 will be eliminated.** Effective date: October 1, 1982 This policy change is identical to that proposed for AFDC. Michigan, however, has not yet implemented this policy in food stamps.	(7.7)

ADDITIONAL SFA ANALYSIS

The Reagan budget fails to include the food stamp costs due to benefit reductions in SSI and AFDC. As a household's benefit income declines due to policy changes or unemployment etc., food stamp benefits increase. These costs are not included in the base or the recommendation, causing substantial underfunding of the account.

The elimination of work expense disregards will result in reduced incentive for people to be employed. If day care and other expenses approach or exceed earnings, no incentive will remain to continue work. Ironically, the policy change accomplishes the opposite of what the President intends. For example, a family of three with no earned income with AFDC benefits of $4,752 per year will receive $276 per year more food stamps than a working family of three with the same net income.

As low income individuals' food purchasing power declines, the food and agricultural industry will likely absorb about a $2 billion reduction in the national marketplace thus depressing already low farm products prices, and increasing inventories. It is also likely that this reduction in purchasing power will not be made up by private funding, but rather in reduced consumption. The Food Stamp program has been credited with increasing the nutritional level of the nation's low-income population. This policy change may result in a reduction in the food purchasing power of the working poor. Working food stamp recipients must either find other ways to meet food costs, or consume less. Reduced food consumption could lead to malnutrition in some cases since the current food stamp budget is based upon a minimally nutritious diet. Medical costs could increase as malnutrition leads to reduced resistance to disease. No cost offsets in Medicaid or emergency assistance are included in the President's budget for these interacting effects.

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SFA/LM/jb
2/18/81-FOODSTFD
REVISED: 2/23/82

SENATE FISCAL AGENCY FEDERAL BUDGET ANALYSIS

LOW INCOME HOME ENERGY (LIEAP) AND EMERGENCY ASSISTANCE CONSOLIDATION
(dollars in millions)

FINANCIAL OVERVIEW

	FY 1980 ACTUAL[1]	FY 1981 ACTUAL[2]	EST. FY 1982 ALLOCATION[2]	FY 1983 RECOMMENDATION[2]	CHANGE FY 1982 TO 1983 DOLLAR	CHANGE FY 1982 TO 1983 PERCENT
National Total:						
Budget Authority	--	$1,907	$1,812.7	$1,300	$(512.7)	(28.3)
Budget Outlay	--	1,791.8	1,925.4	1,300	(625.4)	(32.5)
State of Michigan						
Est. Allocation	—	110.8	108.6	73.3	(35.29)	(32.5)

PROGRAM DESCRIPTION

The family emergency assistance program funded through Title IVa of the Social Security Act has been designed to assist states in providing financial assistance to low-income families faced with emergencies such as eviction, lack of food, shelter problems, shut-offs of utilities, etc.

The Low-Income Energy Assistance Program was established in 1980 to assist low-income families in excessive and rapidly escalating home heating costs. The program is financed through Title III of the Crude Oil Windfall Profit Tax Act, and the Home Energy Assistance Act of 1980. This legislation will expire at the end of 1981 and new legislation is proposed to combine the IVa program with LIEAP for FY 1983. No state match is required. The current year LIEAP program in Michigan was allocated as follows:

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[1] LIEAP did not exist.

[2] Includes both Emergency Assistance and Low Income Energy Assistance allotments

		MILLIONS
a.	Home Heating Tax Credit (100% Federal)	$ 32.7
b.	Special Needs Payment to AFDC & GA Recipients: ($9 million LIEAP; 13.5 GF/GP; 13.5 Federal IVA)	36.0
c.	Emergency Needs Program (LIEAP underwrites home heating emergencies)	20.4
d.	Department of Labor. Community Action Agencies for weatherization and direct assistance for excessive heat consumption cases	10.6
e.	Administration	5.0

TOTAL FY 1982 LIEAP PROGRAMS ALLOCATED AS OF JANUARY 1982		
	GROSS........................	$ 104.7
	LIEAP........................	77.7
	IVA........................	13.5
	GF/GP........................	13.5

PRESIDENT'S RECOMMENDATION AND SENATE FISCAL AGENCY ANALYSIS

	Fiscal Impacts (in millions) National est.	State
The President's budget recommends consolidating the emergency assistance program with the energy assistance progam and then cutting them by 32.5%	$(625.4)	$(45)

The President's budget recommends consolidating the emergency assistance program with the energy assistance progam and then cutting them by 32.5% This comes at a time when Michigan's home heating prices have escalated by over 16% annually and the current assistance grants fall short of home heating costs for the average AFDC household on the voluntary heating fuel program by 43%*. The reduction in emergency aid, in combination with the reductions in AFDC and food stamps, will create a need for state funding pick-up in excess of the $35 million federal reduction. At least another $10 million in food, shelter and heating emergencies can be anticipated due to other policy changes making the total loss approximately $45 million.

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*Source: DSS and data supplied by Michigan Consolidated Gas Company on the 40,000 AFDC cases currently participating.

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SENATE FISCAL AGENCY FEDERAL BUDGET ANALYSIS

SUPPLEMENTAL SECURITY INCOME
(Dollars in Millions)

FINANCIAL OVERVIEW

	FY 1980 ACTUAL	FY 1981 ACTUAL	FY 1982 ENACTED*	FY 1983 RECOMMENDATION	CHANGE FY 1982 TO 1983 DOLLAR	CHANGE FY 1982 TO 1983 PERCENT
National Total:	$	$	$	$	$	
Budget Authority	6,467	7,227	7,878	8,891	1,013	12.8%
Budget Outlays	6,411	7,191	8,000	8,903	903	11.3%
State of Michigan Est. Allocation**	148.8	172.2	187.2	208.4	21.2	11.3%

PROGRAM DESCRIPTION

Supplemental Security Income is a grant program funded with federal and state dollars administered by the federal government to provide cash assistance to low-income individuals who are aged, blind or disabled. SSI payments are made to eligible persons or couples on the basis of their living arrangements. There are five categories:

1) Independent living,
2) Household of another,
3) Supervisory care,
4) Personal care services, and
5) Homes for the aged.

As of January, 1982, the monthly grants ranged from a high of $498.00 for an individual in a home for the aged to $192.67 for a person living in a household of another.

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* Reflects projected appropriated level of funding.
** This federal allocation does not appear within the appropriations act.

PRESIDENT'S RECOMMENDATIONS

In addition to the adjustments made in the current fiscal year namely retrospective accounting, restrictions on funding of rehabilitation services, etc., the FY 1983 proposed federal initiatives would have more of an impact on Michigan's SSI clients.

1) Change definition of disability to reflect only medical qualifications.
2) Change definition of permanent disability to reflect duration of 24 instead of 12 months.
3) Prorate first month's SSI check upon date of application or eligibility.
4) Recover overpayments from Social Security benefits.
5) Repeal the $20 per month income disregard policy.
6) Change policy of rounding benefits from the next higher $.10 to the next lower dollar.

SFA ANALYSIS OF IMPACT ON STATE OF MICHIGAN

While all of the six Executive budget recommendations will have consequences for current as well as prospective SSI recipients, the first four policy changes cited above have a direct bearing on a state's ability to assume greater fiscal responsibility for a group of people previously considered disabled.

The changes in the definition of disability will have consequences for those adults recently released from institutions as well as those SSI clients with marginal or no vocational skills. Should those recipients be found ineligible for SSI, they could by granted assistance through the General Assistance and Emergency Needs Program. Since the state supplemental amount of the SSI check is currently at the lowest possible level (December, 1976), any shift from the SSI program to General Assistance would result in as much as a 50% increase in state costs.

To repeat, the SSI program serves the aged, blind and the disabled. For the most part in Michigan it consists of chronically ill people, adult foster home residents and older clients in homes for the aged. Nationally, the projected savings for the FY 1983 proposals, (most of which are proposed for implementation July 1, 1982), are expected to net $286 million.

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SENATE FISCAL AGENCY FEDERAL BUDGET ANALYSIS

TRADE ADJUSTMENT ASSISTANCE PROGRAM
(dollars in millions)

FINANCIAL OVERVIEW

	FY 1980 ACTUAL	FY 1981 ACTUAL	FY 1982 ENACTED	FY 1983 RECOMMENDATION	CHANGE FY 1982 TO 1983 DOLLAR	CHANGE FY 1982 TO 1983 PERCENT
National Total:						
Budget Authority	$	$ 1,481	$ 144	$ 118	$ (26)	18
Budget Outlays	$ 1,664.3	$ 1,481	$ 144	$ 10	$ (134)	93
State of Michigan Est. Allocation	$ 491.9	$ 554.4	$ 40.0	$ -0-	$ (40)	100

PROGRAM DESCRIPTION

The Trade Adjustment Assistance Program (TAA) is administered by the federal Department of Labor. It was established by Title II of the Trade Act of 1974, and PL 93-618 of 1979. The objective of the federal program is to provide financial assistance to workers who have been adversely affected by the importation of goods and articles. The principle recipients of TAA benefits have been workers employed in the automative industry.

The TRA payments are issued in this state by the Michigan Employment and Security Commission. The state offices are reimbursed for offering the displaced worker, allowances, testing, counseling, training, and job placement services.

In August 1978, Michigan became certified as being eligible for payments because the Chrysler automotive workers were laid off. Michigan began receiving TRA payment for its' employees in October, 1979. The payments were retroactive to the certification date.

In 1981 there were changes in the TAA benefit program as a result of amendments in PL 97 of 1981, the "Omnibus Reconciliation Act". These changes are as follows:

1. Increases in imported articles must be the substantial cause of workers' unemployment.

2. In addition, the TAA benefits are payable only after the worker has exhausted all regular unemployment and extended benefits.

3. Weekly TAA benefits would not exceed the regular state unemployment benefit rate. In addition TAA payments would be reduced by any training allowance and by any income deductible from regular benefits under provisions of state law.

4. The total amount of TAA payments are not to exceed an amount which, when added to regular unemployment insurance entitlement, would exceed 52 times the regular UI weekly benefit rate. Effective 10-1-81.

5. No TAA is payable for any week which occurs more than 52 weeks after the date of exhaustion of regular benefits.

6. This program for senior workers was discontinued.

7. Twenty-six week extension for individuals in approved training who are making satisfactory progress was retained. However, individuals must apply for trainng within 210 days after date of certification or most recent separation, whichever date is later.

8. The federal definition of suitable work and seeking work requirements applicable to EB claims would also apply to TAA claims. Basically, an individual would be required to accept any job within his/her capabilities. Also, after the first 8 weeks of TAA payments, an individual could be required to actively seek work outside of his/her labor market area or agree to accept training in new or related job categories.

9. Job search allowance is increased from 80% to 90% of an individual's necessary expenses, up to a maximum of $600. This was formerly $500.

10. Relocation allowance is increased from 80% to 90% of reasonable and necessary expenses incurred; lump sum maximum was raised $500 to $600.

The changes in the Trade Adjustment Program were effective October 1, 1981.

Between October 1979 and November 1981, more than 309,400 workers had received TAA payments. By the end of 1981, 63,900 persons had exhausted their TAA benefits, and approximately $1.2 billion had been paid to Michigan through TAA benefits.

After the amendments were adopted through the "Omnibus Reconciliation Act", Michigan's eligibility TAA caseload dropped immeditely to approximately 5,000 persons. As a result the new federal guidelines, the current TAA caseload in Michigan is estimated at 1,600.

PRESIDENT'S RECOMMENDATION

The Reagan Administration proposes to maintain the adjustment portion of the TAA program by funding training, job search, and relocation as part of its special program for target groups. This program would be administered from Washington and provide training for specific groups who have difficulties in finding and retaining jobs. It would be merged with training programs which will replace the Comprehensive Employment and Training Programs, CETA. Eligible groups would be migrants, older Americans, Indians and those who qualify for Trade Adjustment Assistance benefits.

Secondly, there would be an elimination of all TAA weekly benefits effective July 1, 1982. The only recipients who would continue to receive their benefits until they expire, would be those individuals who are already enrolled in approved training programs.

The rationale given for these recomendation is that most workers eligible for TAA, have taken advantage of cash benefits and have not used training or other adjustment benefits. Further, that of the 1.3 million workers who received TAA between 1975-81, only 3% entered training, and 1.2% completed training. The administration seeks to emphasize training, job search, and relocation in hopes of encouraging workers to re-enter the workforce.

SFA ANALYSIS OF IMPACT ON STATE OF MICHIGAN

The President's proposal has designated a total amount of $180 million to finance the special target program. The targeted program is to provide training for those eligible for TAA benefits as well as disadvantaged, migrants, veterans, dislocated workers. The special program will have to service many individuals who were formerly served by CETA, TRA, and other training programs. In the past, Michigan has received more than $900 million through trade adjustment and CETA to provide training and stipends to unemployed worker.

There are currently 1,600 persons in Michigan who are yet receiving TAA benefits. Since these individuals have already exhausted their unemployment benefits, unless adequate training programs or employment, or some alternative is found, these individuals will inevitably end up on one of our public assistance programs.

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SFA/2/18/82
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OTHER PROGRAMS

SENATE FISCAL AGENCY FEDERAL BUDGET ANALYSIS

AGING PROGRAMS
(dollars in millions)

FINANCIAL OVERVIEW

	FY 1980 ACTUAL	FY 1981 ACTUAL	FY 1982 ENACTED*	FY 1983 RECOMMENDATION	CHANGE FY 1982 TO 1983 DOLLAR	CHANGE FY 1982 TO 1983 PERCENT
National Total:						
Budget Authority	$ 982.75	$1,030.92	$ 790.46	$ 679.91	$ (110.55)	(13.99)%
Budget Outlays	$ 988.81	$1,057.41(a)	$ 924.25(a)	$ 679.91(a)	$ (244.34)	(26.4)%
State of Michigan Est. Allocation	$ 27.67	$ 29.04(b)	$ 28.54(b)	$ 22.33(b)	$ (6.21)	(21.8)%

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* Based upon continuing resolution (PL 97-92)

(a) The outlays are the percentages of budget authority since detail of individual grant programs is not available for FY 1981, 1982, and 1983, and total outlays for all Human Development Service programs were higher or lower than the budget authority by the following amounts: 1981 = 109%; 1982 = 89.5%; 1983 = 100%.

(b) Michigan Office on Services to the Aging actual allocations and estimated allocations with the exception of Research Training and Discretionary programs that go directly to local agencies. These programs assume Michigan will receive 4.0% of the national outlays.

PROGRAM DESCRIPTION

There are numerous Federal and State programs that provide assistance to senior citizens. These programs fall into 2 categories - direct services provided through the Michigan Office on Services to the Aging and entitlements or services from other federal and state programs.

A. Direct Services through Office on Services to the Aging

The Michigan Office on Services to the Aging (OSA) provides social services - information and referral, counselling, day and evening activities, employment assistance, advocacy, etc. - and nutritional services (congregate and home delivered meals) through its network of 14 area agencies. The emphasis of these programs is maximizing the number of senior citizens who are self-sufficient in their communities and to minimize the number of elderly citizens who require dependent or institutional living.

The Federal and State funding for these local Aging programs in the Office of Services to Aging 1981-82 budget is $35.5 million ($27.8 million Federal and $7.7 million State). These funds are distributed to the 14 area agencies by a formula which is based upon the number of seniors living in each region. Additional credit is given for the number of senior citizens below the poverity level, that are minorities and that live in rural areas.

B. Other Entitlements or Services from Other Agencies

In addition to the programs sponsored under the Office of Services to the Aging, Michigan's seniors also receive assistance through the following major types of programs:

1. Michigan Department of Social Services/U.S. Health and Human Services.
    a. Income Assistance - Social Security and Supplemental Security Income.
    b. Food Stamps.
    c. Medical Assistance - Medicare and Medicaid
    d. Home Help and Chore Services - Title XX.
2. Michigan Department of Transportation
    a. Public transit and bus services including dial-a-ride.

3. Michigan Department of Labor/U.S. Department of Labor
    a. Employment Services - CETA
    b. Social/Winterization, etc. - Community Action Programs
4. Michigan Department of Mental Health
    a. Community mental health programs.
    b. Foster grandparent sponsorship.

These programs also go toward maintaining income and social independence in the communities. Funding goes directly to local agencies or individual senior citizens.

PRESIDENT REAGAN'S 1982-83 BUDGET PROPOSALS

The President's proposals do not change organizational structures, but there is a general reduction in funding levels which will reduce funding in Michigan by $6.2 million or 21.8% for the programs provided through the Michigan Office on Services to the Aging. This doesn't seem like a great deal of money, but when we consider the affect on human lives and the increased number of people who will be forced into dependent or institutional living it is significant.

As an example, Michigan's nutrition programs spends $16.4 million of federal funds and serves almost 9.0 million congregate and home delivered meals a year to about 30,000 individuals. There are approximately 1.1 million people over 60 years of age in Michigan, of which 300,000 have incomes below the poverty level. The reduction of $3.13 million federal support (18.8%) combined with an estimated inflationary cost increase of 6.5% - 7.0% will reduce the number of meals served by 2.0 million annually. The Office of Services to the Aging estimates this may result in 10,000 people being forced into a dependent living situation, which will be more costly for the State and Federal government.

In addition, Michigan is seeing a rise in the demand for services as other programs such as Medicare, Home Help, Public Transportation receive reductions. One recent example is the distribution of federal surplus cheese. During the week of February 15-19, 120,000 pounds of federal surplus cheese was distributed through Community Action Agencies in the Upper Peninsula to 48,000 eligible citizens. When the distribution was completed there was a need for 45,000 lbs. of additional cheese for 18,000 citizens that were eligible and had never applied for any assistance before. When distributions take place elsewhere in the state, a similar situation is likely to occur. It was also discovered these people were eligible for home heating assistance, food stamps and other social services for which they have never applied for but now needed. The Office of Services to the Aging is completing a study of other program reductions and their impact of services provided through their programs and the impact on individual senior citizens.

Michigan is facing a real human needs crisis for all of its citizens and senior citizens are no different with the cost of housing, food and other basic needs rising faster than their incomes. This is likely to further increase the demand for all publicly funded services while there are shrinking revenues.

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SENATE FISCAL AGENCY FEDERAL BUDGET ANALYSIS

COAST GUARD USER FEES

PROGRAM DESCRIPTION

The U.S. Coast Guard provides a number of services for boaters which are provided without charge. Such services include:

- issuing licenses
- inspecting facilities
- certifying vessel construction
- maintaining aids to navigation
- providing rescue and assistance services

PRESIDENT'S RECOMMENDATION

The President has proposed that services provided to boaters become a user fee financed program. Following is the proposed fee schedule.

Lake Classification	Boat Size	Fee
Navigable Rivers	up to 16'	$ 4.00
	16' to 26'	9.00
	over 26'	15.00
Land Lock Lakes	Any Size	4.00
Coastal Waters (Great Lakes)	up to 16'	50.00
	16' to 26'	110.00
	26' to 40'	200.00
	40' to 65'	400.00
	over 65'	600.00

SFA ANALYSIS OF IMPACT ON STATE OF MICHIGAN

The fee is expected to generate $212,000,000 nationwide. Michigan currently has 7.8% of all boat registrations, so a rough estimate of the cost to Michigan citizens would be $16.5 million.

Boating activity in Michigan is divided about 50/50 between Great Lakes boating and inland lake boating. The Coast Guard provides no services to the inland boater, but yet is proposing a $4.00/year fee for services.

The proposal of charging the recreational boater a fee for navigational aids does not appear to be a justifiable charge. The navigational aids which the Coast Guard maintains are primarily of value to commercial shipping. They are of little value to the recreational boater.

In the economic condition Michigan is in, the addition of a $15 to $20 million tax for Coast Guard services would be detrimental to Michigan's effort to attract new business, tourism, and recreation.

The Coast Guard has approached the states with the proposal that the states collect the boat registration fee. In return the states would get approximately $10 million of the $121 million for Boat Safety Programs. Politically, it could be devastating for Michigan to tax its' citizens $15 to $20 million and then turn 95% of it over to the Federal Government.

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SENATE FISCAL AGENCY FEDERAL BUDGET ANALYSIS

EQUAL EMPLOYMENT OPPORTUNITY COMMISSION
(Dollars in Millions)

FINANCIAL OVERVIEW

	FY 1980 ACTUAL	FY 1981 ACTUAL	FY 1982 ENACTED	FY 1983 RECOMMENDATION	CHANGE FY 1982 TO 1983	
					DOLLAR	PERCENT
National Total:	$	$	$	$	$	
Budget Authority	124.6	141.2	139.9	144.9	5.1	3.6%
Budget Outlay	130.8	134.3	143.0	142.0	(1.0)	(.7%)
State of Michigan						
Est. Allocation	4.3	4.4	4.7	4.7	0.3	(.7%)

PROGRAM DESCRIPTION

1. Federal Administering Agency - The Equal Employment Opportunity Commission (EEOC), created in 1964.

2. State Programs supported by EEOC funds - The Michigan Department of Civil Rights (MDCR) Enforcement Bureau, Employment Discrimination and Rapid Care Processing Components.

3. Formula - MDCR is reimbursed in the amount of $412.50 per employment case closed and accepted by EEOC.

4. Length of Time Federal Support has been available - Federal support began in 1964 although it did not reach substantial amounts until the late 1970's. MDCR currently receives $1,850,000 FF, $1,650,000 in employment discrimination monies and $200,000 in rapid case processing monies.

5. Program Objectives - MDCR receives 2 types of federal funds, those being employment discrimination monies and rapid case processing monies. The purpose of the employment discrimination monies is to reimburse MDCR for the cost of processing cases which would ordinarily fall under Federal jurisdiction. It is important to note that the Michgian Civil Rights Act of 1976 requires MDCR to process among others, employment cases. This MDCR would have to process these cases whether or not federal funds were present.

Rapid Case Processing monies are used to implement a faster, more streamlined approach to the case concilliations process.

6. State Resources - $8,323,200 in State GF monies were appropriated to MDCR for FY 1981-82.

7. Clients Affected - 5,743 cases of employment discrimination were docketed for FY 1980-81. 6.5 FTE were supported to implement the rapid case processing program.

PRESIDENT'S RECOMMENDATION

1. Policy Changes - None indicated.

2. Dollar Loss - 1 million

3. Administrative Expenses - None were provided for in the State Contract.

4. Additional State resources - None required.

5. State program assumptions due to the President's recommendations - No assumptions required. See Number 5 under Program Description for further explanation

SFA ANALYSIS OF IMPACT ON STATE OF MICHIGAN

Who will be affected by the President's recommendation - The amount of EEOC funds targeted to states and local units decreases by $500,000 from $18.5 million in FY 1982 to $18 million in FY 1983. Indications are that Michigan will receive basically the same fiscal support as last year. No adverse impact is anticipated.

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SENATE FISCAL AGENCY FEDERAL BUDGET ANALYSIS

HUD SUBSIDIZED HOUSING
(dollars in millions)

FINANCIAL OVERVIEW

	FY 1980 ACTUAL	FY 1981 ACTUAL	FY 1982 ENACTED	FY 1983 RECOMMENDATION	CHANGE FY 1982 TO 1983 DOLLAR	CHANGE FY 1982 TO 1983 PERCENT
National Total:						
Budget Authority	$ NA	$ 17,785	$ 566	$ (3,731)	$ (3,163)	-
Budget Outlays	$ 29,199	$ 3,105	$ 3,493	$ 3,789	$ 291	8.4
State of Michigan Est. Allocation	$ NA	$ NA	$ NA	$ NA	$ NA	

PROGRAM DESCRIPTION

The U.S. Department of Housing and Urban Development (HUD) administers subsidized housing programs to assist low-income families, handicapped, and senior citizens in meeting the costs of adequate living facilities. The basic programs which are administered are: 1) Lower Income Housing Programs (Section 8), which provides rental assistance to low income families for new construction, moderately, or substantially rehabilitated units, when buildings meet federal standards. (2) Public Housing Program, subsidizes the cost of the development, acquisition, leasing, or modernization of housing projects designed for low income households. (3) Rent Supplement Program (Section 235) provides rent supplement payments to owners of private dwellings and apartment project owners on behalf of qualified low-income tenants. (4) Homeownership program (Section 235) provides homeownership to low income families by subsidizing monthly mortgage payments.

In Michigan, there federal subsidy programs, with the exception of the Public Housing Program, are administered by the Michigan State Housing Development Authority within the Department of Commerce.

The Public Housing Program is administered by HUD through localities and public projects. The federal government operates the public housing program in the two following ways:

1) It pays the full construction costs by annual debt service installments; and

2) About 50 percent of operating costs are paid by operating subsidies. The operating subsidies were used since tenant rent contributions have been inadequate to cover operating costs.

PRESIDENT'S RECOMMENDATION

In 1982, the budget authority for Public Housing is $1.293 million. In 1983, the Reagan administration is proposing to eliminate funding for additional public housing units because the program has been expensive to construct and maintain.

The administration is also proposing to replace the Section 8 existing Housing Program with a Modified Section 8 Housing Certificate Program. Under the modified program, there would be no "rent level" equal to the "fair market rent". Instead, tenants would select housing themselves. The modified program would provide the tenant rental assistance directly and permit the subsidy recipients (Housing Certificate holders) to select the type and cost of the unit. The value of the Certificate will be based on a payment standard reflecting area rental costs and the tenant's income level.

The Modified Program will be used in conjunction with a HUD Rental Rehabilitation Initiative Grant. Currently, federal government subsidizes the rehabilitation of multi-family rental properties known as the Setion 8 Moderate Rehabilitation Program and Loan Fund. The administration proposes to terminate the Section 8 Moderate Rehabilitation Program and the Rehabilitation Loan Fund and substitute a new block-grant program for subsidizing multi-family rental rehabilitation. This program will be called the Rental Rehabilitation Grants, and would be linked to the previously mentioned Modified Section 8 Housing Certificate Program. The budget authority for Rental Rehabilitation Grants is $150 million. The grants would go to state and local units of government for 50% of the cost of rehabilitating multi-family rental properties for low income families. The subsidized housing program grew from $2.9 billion in 1978 to $5.8 billion in 1981. The program has been costly and therefore it has also been recommended that subsidized housing for new construction be terminated with the exception of 10,000 housing units for elderly and handicapped.

In 1983, it has been recommended that all new occupants of HUD subsidized housing have their rents set at 30% of their income, and that the cash value of food stamps be added to cash income when calculating the required rent contribution of families. In addition, that tenants whose monthly utility bills exceed 25% of their adjusted income will no longer receive monthly payments from HUD for amounts in excess of the rent ceiling. Inclusive in this recommendation is a provision that certain tenants will experience rent increases in excess of 10% per year under the above proposals. Legislation is to be proposed to increase the limit on the rate of annual rent increases from 10 percent to 20 percent of family income.

It is also recommended that all 172,300 projects operated under the Rent Supplement and Rental Assitance Payment (RAP) programs in FHA-insured projects will be converted to the Section 8 existing program. The Section 8 existing program has provision built into the subsidy mechanism for needed increases. Consequently, long-term solutions can be provided for funding. It is hoped that this move will deter defaults ad subsequent claims against the FHA funds since rents could be raised without placing intolerable burdens on tenants and creating high turnover and vacancy rates.

Under the housing programs for the elderly and handicapped, the President is proposing to allow for competitive bidding in the construction of Section 202/8 projects (Handicapped/Elderly/low-income), and subject those programs to the same costs controls as the other housing programs. These programs will also be geared away from new construction, towards a lower cost modified Section 8 Housing Certificate Programs.

SFA ANALYSIS OF IMPACT

Michigan receives its heaviest subsidizes under Section 8 programs which offer reimbursement for low income families.

The program has been substantially revised as a result of a decision to emphasize the use of the existing housing inventory in lieu of new construction. All subsidizes for new construction or substantial rehabilitation will be discontinued.

In Michigan, between 1978 and 1981, approximately 3,000 new rental units have been constructed annually under Section 8 new construction. The costs of new construction averages approximately $4,000 per rental unit. The assistance payments range as much as $17,000 per family. These payments are provided for a period of 20 to 40 years, which represents the life of the mortgage. The majority of construction work is used to provide substantial renovation or build new constructions. The moderate rehabilitation would simply enable owners to bring existing dwellings up to code and make minor improvement. If the new construction and the substantial rehabilitation programs are discontinued, it would be a substantial savings to the federal government. However, it would limit individuals to living in older housing which had been "moderately" rehabilitated, and it would also reduce jobs in the construction industry substantially.

Another recommendation which would effect Michigan residents in particular is utility rates. In the winter months, Michigan faces very cold weather, and this is reflected in utility usage. Should the federal government discontinue rent reimbursements to tenants who pay more than 25% of their income for utility costs, this will have a substantial impact on recipients. In 1981, the state's medium income for multi-families was $8,282. The average weekly wage would be $159.00. Twenty-five percent of this amount would place a ceiling on utility rates of $39.00. In addition, should cash value of food stamps be used to compute income levels, a heavy impact will be felt because rent payments wuld be adjusted accordingly.

Under the recommended changes in the rent supplement programs, individuals would yet be eligible to recieve rent supplements. However, the new subsidy will be based on the concept of providing housing certificates to low income households. This will enable the individuals to be responsible for selecting their own housing facilities in the private market, rather than government approved housing. This will also help deter the practice of congregating low income residents in one building, and in one setion of town.

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Senate Fiscal Agency 2/23/82
ge/we81/fedhud

SENATE FISCAL AGENCY FEDERAL BUDGET ANALYSIS

DEPARTMENT OF JUSTICE
LAW ENFORCEMENT ASSISTANCE ADMINISTRATION
(dollars in millions)

FINANCIAL OVERVIEW

	FY 1980 ACTUAL	FY 1981 ACTUAL	FY 1982 ENACTED*	FY 1983 RECOMMENDATION	CHANGE FY 1982 TO 1983 DOLLAR	PERCENT
NATIONAL TOTAL:						
BUDGET AUTHORITY						
a) Juvenile Justice Formula Grants	$ 63.75	$ 61.79	$ 43.10	$ -0-	$ (43.10)	(100.0)%
b) Juvenile Justice Programs	36.25	35.28	24.50	-0-	(24.50)	(100.0)%
c) Crime Control Grants	332.70	-0-	3.80	-0-	(3.80)	(100.0)%
d) Public Safety Officer's Benefits	10.00	12.50	10.13	10.80	.67	6.6%
e) Federal Administration	-0-	14.67	12.02	7.71	(4.31)	(35.9)%
TOTAL BUDGET AUTHORITY:	$ 442.70	$ 124.24	$ 93.55	$ 18.51	$ (75.04)	(80.2)%
BUDGET OUTLAYS						
a) Grants (a-c above)	$ 421.28	$ 107.86	$ 88.43	$ -0-	$ (88.43)	(100.0)%
b) Public Safety Officer's Benefits	11.38	13.00	10.75	10.85	.10	.9%
c) Federal Administration	40.74	24.19	20.02	7.71	(12.31)	(61.5)%
TOTAL OUTLAYS:	$ 473.40	$ 145.05	$ 119.20	$ 18.56	$ (100.64)	(84.4)%

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*Based upon continuing resolution (P.L. 97-92)

FINANCIAL OVERVIEW (Continued)

	FY 1980 ACTUAL	FY 1981 ACTUAL	FY 1982 ENACTED*	FY 1983 RECOMMENDATION	CHANGE FY 1982 TO 1983 DOLLAR	CHANGE FY 1982 TO 1983 PERCENT
STATE OF MICHIGAN EST. ALLOCATION						
a) Juvenile Justice Formula Grants (4.6%)	$ 2.73	$ 1.46	$ 1.88	$ -0-	$ (1.88)	(100.0)%
b) Juvenile Justice Programs (.8%)	.40	-0-	.42	-0-	(.42)	(100.0)%
c) Crime Control Grants (4.3%)	15.41	7.04(a)	4.19(a)	-0-	(4.19)	(100.0)%
d) Public Safety Officer's Benefits (0%)	-0-	-0-	-0-	-0-	-0-	-0-
e) Federal Admin. (.4%)	.01	-0-	-0-	-0-	-0-	-0-
TOTAL MICHIGAN ALLOCATION:	$ 18.55	$ 8.50	$ 6.49	$ -0-	$ (6.49)	(100.0)%

PROGRAM DESCRIPTION

The Department of Justice has provided financial assistance to State and Local governments since the inception of the Law Enforcement Assistance Administration (LEAA) in the late 1960's. The Office of Criminal Justice in the Department of Management and Budget is Michigan's administrative organization for planning and grants management. The Office is under the supervision of the Commission on Criminal Justice composed of 37 state and local officials and citizens dealing with all segments of the criminal justice system. The Justice System Improvement Act of 1979 limited the focus of the LEAA programs to the Juvenile Justice and Delinquency Prevention Programs with the following emphasis:

(a) $3.1 million is eligible for pass through to Local Governments for Juvenile Justice Programs.

PROGRAM DESCRIPTION (Continued)

1. Remove status offenders and non-offenders from secure detention facilities;
2. Removal of juveniles from adult lock-ups and jails;
3. Prevention of delinquency; and
4. Meeting the needs of serious and violent offenders.

Since 1980-81, the funding for the original Omnibus Crime Control Grant program has been terminated other than for projects which were started before 1980 with a 1981 or 1982 completion date. Such projects are called "projects with funds in the 'pipeline'" - usually an agency has 15-30 months to complete a project. The 1981-82 budget for the Office of Criminal Justice included $653,800 of additional General Fund support for the loss of federal funds under the Omnibus Crime Control Grants program. These funds were to ensure continued statewide planning and program evaluation. The Grants program has been reduced from $15.0 million annually to -0- for general law enforcement activities. These funds went primarily to local agencies to support specific police, court, prosecution and correction activities. Local communities have been required to terminate any programs or use local funding for support. There has been no State funding to replace these federal funds.

PRESIDENT REAGAN'S 1982-83 BUDGET PROPOSALS

The President's proposal is to eliminate the Grants portion of the program entirely. The only programs funded that could be of benefit to Michigan are some correctional training programs, collection and dissemination of criminal justice statistics (Uniform Crime Reports and the National Crime Survey) and technical assistance in such areas as forensic laboratory services.

The rationale for this policy change as presented in the President's Budget message, is that:

1. "Public safety is primarily a state and local responsibility..... State and local governments are expected to continue to spend eight times the amount the Federal Government spends ($4.6 billion) for administration of justice programs."

2. "An important theme in the administration of justice in 1983 is for the Federal Government to improve the Nation's law enforcement - not through the past practice of financial assistance to state and local governments - but through the more direct approach of Federal law enforcement agencies cooperating closely with their state and local counterparts." (The budgets for the FBI and Drug Enforcement is up $74 million or 7.6%).

PRESIDENT REAGAN'S 1982-83 BUDGET PROPOSALS (Continued)

3. "Services currently provided through Juvenile Justice and Delinquency Prevention Programs (JJDP) would be provided under broader authorities of programs proposed for consolidation into a social services block grant ..... This shift in delivery mechanism would eliminate Federal bureaucratic red tape and unnecessary state and local administrative costs, and make relatively more funds available for real program needs."

Unfortunately, the loss of $5.0 - $6.0 million for juvenile justice programs under these Federal grants cannot be made up with the Social Service Block Grant which consolidates several programs and reduces the funding by 20%. This is the first time we are aware that the Social Services Block Grant program is to include JJDP programs.

1981-82 AND 1982-83 MAJOR STATE PROGRAM IMPACTS

	1981-82 Appropriation	1981-82 Gov. Recomm.
1. Juvenile Justice Programs (DSS)	$ 1,838,400	$ 2,377,100

The emphasis of funding has been developing alternatives to secure detention and lock-ups of youth in adult jails. During the last six years there has been significant improvement in this area - status offenders housed in secure detention facilities were reduced from 1,671 to 53. However there are still significant jailings of youth in adult jails and lock-ups (3,300 in 1978). This is a particular problem in smaller counties that may not have shelter care facilities or other alternatives for runaways or other youth. Without continued federal support, the development of alternatives will be difficult.

	1981-82 Appropriation	1981-82 Gov. Recomm.
2. Juvenile Justice Programs - Local Grants	$ 3,100,000	$ 3,100,000

The Office of Criminal Justice also allocates funding to local agencies/programs. These funds are used for the same purposes as the DSS funds above.

1981-82 AND 1982-83 MAJOR STATE PROGRAM IMPACTS (Continued)

	1981-82 Appropriation	1981-82 Gov. Recomm.
3. Central Planning and Evaluation	$ 1,152,500	$ 518,400

The Office of Criminal Justice provides overall planning and evaluation of criminal justice programs at all levels of government (state, county and local). The Governor's 1982 budget already contemplates a $634,100 reduction in Federal funding. A further reduction would reduce staffing by 10-12 positions from the current authorized level of 31. This could further reduce the State's ability to provide technical assistance including needs identification and evaluation to local units of government and state agencies so that we can have a comprehensive Criminal Justice Policy.

The elimination of federal support for Law Enforcement and Criminal Justice Programs will be particularly felt in Michigan. With the current high unemployment levels, increased property and violent crimes, and reduced State and Local government revenues, Michigan is facing a very difficult time. Local police agencies and prosecuters are seeing reduced staffing, court dockets are increasing, correctional facilities are overcrowded, etc. Federal financial support would be very helpful over the next few years until Michigan's financial picture can "turn the corner".

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psh/go/fblawenf

NATIONAL GUARD CENTERS CONSTRUCTION
(dollars in millions)

FINANCIAL OVERVIEW

	FY 1980 ACTUAL	FY 1981 ACTUAL	FY 1982 ENACTED*	FY 1983 RECOMMENDATION	CHANGE FY 1982 TO 1983	
					DOLLAR	PERCENT
National Total:						
Budget Authority	$ ---	$ -0-	$ -0-	$ -0-	$ ---	---
Budget Outlays	17.8	30.0	30.0	34.0	4.0	13.3
State of Michigan						
Est. Allocation	0.7	1.2	1.2	1.3	.1	13.3

PROGRAM DESCRIPTION

Army National Guard, for construction, acquisition, expansion, rehabilitation and conversion of facilities for the training and administration of the Army National Guard.

This program provides funding for facilities for the administration and training of approximately 10,000 National Guardsmen who train evenings and weekends at the 52 National Guard Armories. Federal support for this program dates back to World War I.

Approximately 10,000 National Guard members utilize these facilities for training and the facilities are used by many thousands of citizens statewide for community related functions and private functions.

Minimum state resources are required for the initial cost of construction. For example, the new Armory to be built at Montague with a total cost of $2,083,000 will only require a state match of $283,000.

The objective of the program is to provide facilities for the training of the National Guard members.

PRESIDENT'S RECOMMENDATION

The President's recommendation coincides with his stated policy to increase resources for national defense.

Some additional state funds will be required if the federal dollars are accepted but would be very minimal.

SFA ANALYSIS OF IMPACT ON STATE OF MICHIGAN

Many of the members of the National Guard and those citizens that utilize the National Guard armory facilities will be affected by this change in policy as more funds are going to be available to maintain, renovate and replace these facilities.

To the extent that matching funds are required, the Legislature has the option of turning down funds available.

The new funding level will enable the department to upgrade its building maintenance program, but due to underfunding in the past, it will be many years before the program is brought up to date.

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